



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



CPA Texas Society of
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Introduction

The United States is currently experiencing a significant budget deficit with expenditures projected to exceed income by nearly \$845 billion for the fiscal year ending September 30, 2013.¹ Lawmakers face difficult trade-offs in deciding how to reduce this deficit. Some proposals target tax provisions safeguarding one of the most important sectors of our economy—the oil and gas industry.²

While reducing the deficit is a desirable goal, any such efforts should be approached in a responsible manner that does not create new, unforeseen problems for our economy and national security. For example, raising taxes on oil and gas exploration and development should be weighed against the potential negative impact that such increases would have on employment and our country's need for a secure source of energy.

The oil and gas producers have been suggested as a potential source of additional tax revenue in the past, and current budget proposals once again threaten to strip tax-based incentives that have long fueled investment in this important economic sector. The Administration's fiscal year 2014 budget proposal calls for increased taxes on the industry to “eliminate unnecessary fossil fuel subsidies that impede investment in clean energy sources.”³ However laudable these goals may be as long-term objectives, studies have shown that such tax increases would have serious and immediate negative impact upon our economy. Research indicates that they would significantly discourage domestic production, leading to fewer well-paying American jobs, increasing our reliance on imported oil, and resulting in a higher cost of living for American consumers.⁴

Although the general public often associates the oil and gas industry with huge multinational corporations, 95 percent of the nation's oil and natural gas wells are actually drilled by small businesses, referred to in the industry as “independent producers.”⁵ These independent producers employ, on average, no more than 12 people each⁶—meaning that the vast majority of our nation's new wells will be drilled by companies that are economically much more vulnerable than the huge multinational corporations that serve as the focal point of calls for tax reform in this area. These small business independent producers serve an integral role in our nation's oil and gas industry, and rely upon the tax incentives discussed below, which serve to keep domestic jobs from being exported overseas and help to mitigate the exposure of our country's energy supplies to the risks and uncertainty stemming from international conflicts. It is important that our tax policies encourage domestic exploration and development by small business independent producers in order to protect capital and jobs from shifting overseas.

This article highlights the effect that the repeal of certain tax code provisions would have upon these small independent producers and the economy as a whole. It focuses on seven provisions subject to current proposals calling for repeal:



1. deductions for intangible drilling costs,
2. percentage depletion,
3. the domestic production activities deduction,
4. the deduction for tertiary injectants,
5. the amortization of geological and geophysical expenditures,
6. the use of the LIFO method for accounting for oil and gas inventories, and
7. the exception to the passive loss limitation rules for working interests in oil and gas properties.

While the Administration's FY 2014 budget proposal estimates repealing these provisions would generate over \$90 billion⁷ in tax revenue through 2023, their repeal would also have undesirable ancillary consequences that militate against the proposals.

Importance of Oil and Gas Drilling to the Economy

According to the International Energy Agency, by 2020, the U.S. will surpass Saudi Arabia and become the world's largest oil producer, becoming energy independent by 2030.⁸ Our petroleum product exports exceeded imports in 2011 for the first time in over six decades.⁹ Greater fuel autonomy helps boost household incomes, jobs and government revenue, reduces the balance of trade deficits that are a drag on our economy, supports our national defense, and makes our country a more competitive manufacturer.¹⁰ Approximately 11 percent of U.S. oil goes into the making of petrochemicals for common everyday products like antibiotics, deodorant, clothing, computers, phones, plastics and tires.¹¹

Nationwide, the oil and gas industry provides jobs for more than 9.6 million American workers—employing about 2.6 million directly and nearly 7 million indirectly, which represents 5.5 percent of all U.S. employment.¹² The industry added total value of \$1.1 trillion in 2011, or 7.3 percent of the U.S. gross domestic product.¹³ Moreover, the industry has invested \$2.4 trillion in domestic capital projects since 2000.¹⁴ Although the Administration suggests that the oil and gas industry receives “subsidies,” they are incentives to the industry to encourage production; oil and gas companies pay nearly \$100 million a day in federal and state taxes.¹⁵ The oil and gas incentives were put in place by Congress with the express purpose of stimulating domestic production, job growth and favorable energy prices. The discussion below sets forth the results that these Congressionally enacted tax policies have helped achieve.

The oil and gas industry supports 9.6 million U.S. jobs.

Advancements in drilling technology have opened up huge shale gas reserves in the U.S., generating almost \$63 billion in federal, state and local tax receipts in 2012.¹⁶ Nearly 1.2 million jobs from shale activity in 2012 have been created in 10 states with a projection to exceed 2.3 million jobs by 2035: Arkansas, California, Colorado, Louisiana, North Dakota, Ohio, Oklahoma, Pennsylvania, Texas, and Utah.¹⁷ This activity has also boosted employment in ancillary industries, adding tens of thousands of additional jobs to non-producing states that produce goods and services vital to the oil and gas supply



chain:¹⁸ Florida, Georgia, Illinois, Michigan, Minnesota, Missouri, New Jersey, New York, North Carolina, and Wisconsin.¹⁹ Gas drilling in the Marcellus formation will help make Pennsylvania one of the top employment gainers in 2013.²⁰ North Dakota, boasting the lowest unemployment in the nation at 3.2 percent,²¹ represents how energy development can be a powerful engine for economic growth. Its Bakken formation supports 11.8 percent of the state's economy.²² The industry supports 25 percent of the economies of Texas and Wyoming.²³ Texas' Eagle Ford shale generated \$61 billion in economic output and 116,000 full-time jobs for a 20-county region in 2012.²⁴

Some foreign countries have enormous proven reserves that avoid the costs of exploration, resulting in a lower cost per barrel than domestic reserves. Existing tax policies should encourage domestic exploration and development by leveling the cost disadvantage of high-cost domestic production, thereby protecting capital and jobs from shifting to foreign production.

Financing Oil and Gas Drilling

The oil and natural gas industry is characterized by long lead times, huge capital requirements, delayed returns, volatile commodity prices and high investment risks before production is achieved. About 35 percent of exploratory drilling in the U.S. results in dry holes.²⁵ Financial institutions are generally precluded from participating in speculative oil and gas projects, leaving private equity investors to provide the funding—most onshore wells in the U.S. are drilled by independent producers funded by private equity.

Congressionally enacted tax policy long ago implemented pro-investment laws to encourage exploration and development that became instrumental in our economy and financial market decisions. The tax policies permitted the immediate deduction for intangible drilling costs and percentage depletion under the Internal Revenue Code (Code) for more than 87 years,²⁶ and investors have long relied on this incentive. Congress recognized that without these policies, the inherent risks and nature of the industry would present strong impediments to raising funds for exploration and production activities. The policies are not unique to oil and gas—similar provisions apply to the mining and other industries which face similar risks and natural deterrents to investment.

Tax Treatment of Oil and Gas Drilling

Intangible Drilling Costs

The 50 largest independent producers reinvest 150 percent of their cash flow back into new American production.²⁷ Drilling a well is capital intensive and, even if the well is successful, it can take several years of production before the income covers these costs. Without rapid recovery of these drilling expenditures, investors face a high-risk venture with, at best, a long-term return of their investment. This would deter many investors from providing the capital necessary to generate the potential widespread economic benefits that this industry promises. Recognizing this inherent deterrent to investment, our tax laws have long permitted taxpayers to elect to currently deduct the cost of preparation and drilling



expenses—technically known as intangible drilling costs (IDCs)—which typically represent 60 to 80 percent of the well cost.²⁸ The costs would eventually be fully deductible over the life of the well even without this Code provision and, for dry holes, these same costs are immediately deductible. Accordingly, permitting the deduction “up front” has no effect on the long-term revenues of the U.S. government, but the investor recovers costs over a shorter period of time, thereby encouraging investors to make high-risk investment.

If domestic producers lose their IDC deduction, at least one study estimated the result will be an almost immediate one-third reduction in drilling budgets.²⁹ The impact from the loss of this deduction alone could thus be devastating to our economy.

Percentage Depletion

If the well is successful and productive, the tax law—since 1926—has permitted investors to claim a “percentage depletion” deduction, limited to a set amount of production per year and 65 percent of taxable income. These limitations ensure that only the smallest producers and royalty owners receive the full benefit of the deduction. (Congress repealed the percentage depletion allowance for the major oil companies in 1975.³⁰) Percentage depletion reduces the investor’s basis in their investment. Percentage depletion can exceed the basis of the property. Like the “up front” deduction for IDC previously discussed, timing is important to the investors. Importantly and as a practical matter, this benefit enables continuing production from otherwise marginal wells that may be individually insignificant, but collectively add materially to domestic production.

The Domestic Production Activities Deduction

Congress enacted Code section 199 in 2004 to assist U.S. companies competing in the world economy, and to stimulate investment and job growth in the production/manufacturing sector.³¹ Most U.S.

Ending tax deductions that support the small independent producers would make many wells unprofitable.

producers and manufacturers qualify for a 9 percent deduction, but in 2008 the oil and gas industry was capped at a 6 percent deduction. Under the FY 2014 legislative proposal, it is asserted that the deduction “distorts markets by encouraging more investment in the oil and gas industry...”³²

If the domestic production activities deduction were repealed, it would further tilt an unlevel playing field for America’s industrial complex to compete with foreign producers and manufacturers. It would also disproportionately affect small businesses that represent the majority of the industry and job growth. A

Wood MacKenzie study in 2010 concluded that the economic failure rate of the wells studied would increase by 14 percent without Code section 199 and IDC deductions.³³

Deduction for Tertiary Injectants

As oil is pumped from the ground, liquids and gasses are injected back into the earth to maintain open channels and to keep pressure up in the well. This use of tertiary injectants extends the productive life of marginal wells. Since 1980, Treasury Regulations (under Code section 193) have allowed the expense of tertiary injectants to be deducted in the year of the injection or in the year the costs are paid, if later. This



tax treatment—and based on the national policy to incentivize domestic production—was carefully considered and it is well-reasoned, simple, and administrable.

Some have proposed that this provision be eliminated. This would again raise questions about the proper recovery of these expenditures, an issue that has been settled for the past 30 years. Although tertiary injectants are intended to increase the productivity of the well, there is no direct measurement that correlates between the injection and the subsequent production. Consequently, allocating this cost to inventory would be both difficult and imprecise. For example, some of the injectants may be pumped back out of the well along with the oil or gas. Moreover, the “useful life” of these injectants depends on many factors, including the market price of oil, the additional production gained by use of the injectants, and the overall production costs of the well. Eliminating the current deduction would be a mere timing difference as to when the deduction would be taken, but with a lack of clarity and certainty. These are legitimate current expenses, reflecting the unique circumstances of crude oil recovery.

Finally, delaying the deduction of tertiary injectants would have a negative effect on the after-tax cash flow from older wells resulting in otherwise marginal wells being permanently plugged and abandoned, thereby eliminating a source of domestic energy production. This would potentially increase the cost of oil and adversely affect the economies of local communities where these older wells are located.

Amortization of Geological and Geophysical Expenditures

Geological and geophysical (G & G) expenses are incurred in studying a tract of land's potential for exploration or development. Costs generally include geological searches of the surface for indications of hydrocarbons, geological mapping, topographical mapping, aerial photography and radiation surveying to name a few. These expenditures are mostly for wages paid to skilled workers.

Under current law, independent producers and smaller integrated producers are allowed to amortize G & G expenses over two years,³⁴ while major integrated oil companies must amortize them over seven years. Thus, the primary beneficiaries of this tax treatment are the smaller independent producers that have greatly expanded the potential oil and gas reserves in the U.S. through exploration of new domestic shale plays, furthering the goal of energy independence and affordable energy costs.

The proposal to lengthen the amortization period for all producers is a timing difference that may disrupt a segment of energy development that has been functioning exactly as Congress intended when this provision was passed. It could also have an immediate impact on small businesses in the G & G service industry.

Use of the LIFO Inventory Method for Oil and Gas

The last-in, first-out (LIFO) inventory method requires that the cost of the most recently acquired goods be taken into account against current sales revenues. There are good reasons why the LIFO method of accounting for inventories and cost of goods sold has been available to businesses for financial accounting and tax accounting since the 1930s. LIFO reflects the results of operations more accurately by matching current costs with current revenues.



Like other industries that sell products, oil and gas companies must maintain a “base” level of inventory to enable them to serve their customers’ demand in a timely manner. It accurately reflects income to value of this “base” level as the cost when it was established.

The Administration’s FY 2014 proposal would repeal the use of the LIFO method for all tax years beginning after December 31, 2013.³⁵ Such a change from LIFO to first-in, first-out (FIFO) would artificially raise taxable income by requiring the use of lower cost inventories against current revenues. Businesses currently using LIFO would continue to have the same revenues and the same inventory replacement costs. The only difference would be that they would be subject to higher taxes as they offset revenues from current sales with the cost of their “base” inventories incurred decades ago. LIFO repeal would cost the energy industry approximately \$28.3 billion,³⁶ funds that could otherwise be used for exploration and development of energy resources.

Passive Loss Exception for Working Interests in Oil and Gas Properties

The passive loss rules generally defer losses from trade or business activities in which the taxpayer does not materially participate. The unused losses are carried forward indefinitely or until the investor makes a tax disposition of the investment or generates net income from other passive activities.

For 27 years, the tax law has provided an exception to the passive loss rules where an investor owns a working interest in an oil or gas property, thereby incurring continuing risk for operating and other losses and expenses from the operation.³⁷ As previously stated, typically drilling activities produce losses in the early years. Without this exception, the current benefits of the deduction for intangible drilling costs and percentage depletion would be deferred until the well becomes profitable (or until the investors sell their interests). Investors look to the current tax benefits of these deductions as a mitigating factor to the high risk of oil and gas exploration. 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 high-risk energy exploration and development projects. Oil and gas operations are important not only to the economies of Texas and many other energy producing states, but to the country as a whole. Without the current tax treatments, less capital will be available for oil and gas projects, resulting in fewer jobs, a slower economic recovery, and more dependence on less reliable foreign energy sources.

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



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- ¹ Congressional Budget Office, “The Budget and Economic Outlook: Fiscal Years 2013 to 2023” (February 2013).
- ² This analysis is focused on the impact of various tax proposals on the domestic oil and gas industry. Thus, it does not address proposals impacting primarily international operations (e.g., the “dual capacity rule”).
- ³ Office of Management and Budget, “Fiscal Year 2014 Budget of the U.S. Government” (April 2013), 89.
- ⁴ American Petroleum Institute, “FY2014 Budget Calls for \$90 Billion in Targeted Tax Increases on America’s Oil & Natural Gas Producers” (April 2013).
- ⁵ The Independent Petroleum Association of America (IPAA), Declaration of Independents’ Analysis (March 22, 2012).
- ⁶ *Ibid.*
- ⁷ Department of the Treasury, “General Explanations of the Administration’s Fiscal Year 2014 Revenue Proposals” or “Green Book” (April 2013); and *Ibid.*, API. Green Book scores may be flawed if assuming that revenues remain constant despite an increased tax burden which would reduce activity.
- ⁸ Mark Thompson, “U.S. to Become Biggest Oil Producer – IEA” (November 12, 2012), *CNNMoney London*, based upon International Energy Agency’s World Energy Outlook 2012, New Policies Scenario.
- ⁹ Adam Sieminski, EIA, “U.S. Energy Outlook for International Monetary Fund” (January 14, 2013), statistics of annual U.S. net exports of total petroleum products 1949 – 2011.
- ¹⁰ Shobhan Chandra, “Oil Exports Trim U.S. Deficit as Fuel Gap Shrinks: Economy” (February 7, 2013), *Bloomberg*.
- ¹¹ Alternative Energy, “How the U.S. Uses Oil” (August 3, 2009); The Daily Green, “From Aspirin to Upholstery: 60 Surprising Products Made from Oil” (May 4, 2010).
- ¹² PricewaterhouseCoopers LLP, “Economic Impacts of the Oil and Natural Gas Industry on the US Economy in 2011” (December 19, 2012), 6-7. Industry suppliers estimated at 5.8 million indirect/induced and capital support at 1.2 million indirect/induced. Induced impact is measured as the jobs, labor income, and value added resulting from household spending of labor and proprietor’s income earned either directly or indirectly from industry spending.
- ¹³ *Ibid.*, 8. Value added consists of: employee compensation, proprietors’ income, income to capital owners from property, and indirect business taxes (including excise taxes, property taxes, fees, licenses and sales taxes paid by businesses).
- ¹⁴ API, “Putting Earnings into Perspective” (January 2012), based on industry capital spending surveys by Dahlman Rose & Co (now Cowen Securities LLC) and published in *Oil & Gas Journal*, survey predicted 11% increase in U.S. oil and gas companies’ spending for 2012.
- ¹⁵ Christopher Prandoni, “A Look Behind the Oil and Natural Gas Industry’s Numbers” (October 27, 2011), Americans for Tax Reform, includes \$86 million a day in federal taxes.
- ¹⁶ *Ibid.*
- ¹⁷ IHS Global Insight Report, “America’s New Energy Future: The Unconventional Oil and Gas Revolution and the U.S. Economy Vol. 2 State Economic Contributions” (December 2012), 13.
- ¹⁸ The Hamilton Project, “The Role of Oil and Gas in Driving Job Growth” (June 1, 2012), 3.
- ¹⁹ *Ibid.*, IHS.
- ²⁰ Kiplinger, “10 States Adding the Most Net Jobs in 2013” (March 2013), ranked Pennsylvania sixth place based on Bureau of Labor Statistics, IHS Global Insights, Moody’s Analytics, Federal Reserve Bank of New York, and state economic data sources.
- ²¹ National Conference of State Legislatures, 2012 State Unemployment Rates.
- ²² *Ibid.*, The Hamilton Project.
- ²³ Douglas A. McIntyre, “The Most Oil-Rich States” (April 3, 2012), *24/7 Wall St.*
- ²⁴ Study by University of Texas at San Antonio Institute for Economic Development, The Center for Community and Business Research (March 26, 2013).
- ²⁵ U.S. Energy Information Administration, U.S. Dry Exploratory Wells Drilled (Number of Elements) Monthly History. EIA recorded 1,011 dry wells out of 2,833 total exploratory wells drilled in 2011.
- ²⁶ IPAA, “Timeline History of Natural Gas and Oil Tax Provisions” (January 2012), IDC expensing in Code since 1913 and percentage depletion in Code since 1926.
- ²⁷ The US Report, “Oil, Gas Producers to Obama: Encourage Energy in US, Not Other Countries” (March 30, 2011), based upon John S. Herold Inc. (now IHS) survey.
- ²⁸ *Ibid.*, API, “FY 2014 Budget...”
- ²⁹ Congressional Research Service Report for Congress, “Oil and Natural Gas Industry Tax Issues in the FY2013 Budget Proposal” (March 2, 2012), based upon IPAA estimates.
- ³⁰ Tax Reduction Act of 1975 (Pub. L. No. 94-12), USC 613 - Sec. 613A: Limitations on percentage depletion in case of oil and gas wells.
- ³¹ The American Jobs Creation Act of 2004 (Pub. L. No. 108-357).
- ³² *Ibid.*, Treasury Green Book, 77.
- ³³ Wood Mackenzie Energy Consulting, “Evaluation of Proposed Tax Changes on the US Oil & Gas Industry” (August 2010), 7.
- ³⁴ Title XIII The Energy Tax Incentives Act of 2005 of The Energy Policy Act of 2005 (Pub. L. No. 109-58).
- ³⁵ *Ibid.*, Treasury Green Book, 88.
- ³⁶ *Ibid.*, API, “FY2014 Budget...” estimated oil and natural gas industry share of LIFO total in OMB budget score.
- ³⁷ The Tax Reform Act of 1986.