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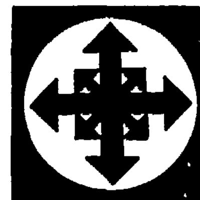

Tax Burden of the Oil and Gas Industry

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Abstract

This paper describes the existing tax climate, summarizes the industry's favorable treatment under the federal income tax law, discusses current federal income tax problems, notes the magnitude of state and local taxes and attempts to predict future tax developments. (Those who are interested in a detailed explanation of the taxes imposed upon the industry can discover a wealth of material in publications of the Mid-Continent Oil & Gas Assn., the Petroleum Industry Research Foundation and the API.)

The Tax Climate

Information compiled by the API reveals that the industry paid $2.5 billion in federal, state and local taxes on earnings, operations and properties in 1966. In 1965, the direct tax burden was $2.0 billion and in 1964, $1.7 billion. In addition to these direct taxes, sales and excise taxes on gasoline and other products amounted to $8 billion in 1966. Taxes paid to other countries by members of the industry are not included in these amounts.

For 1965, the 27 leading companies paid 5.43 cents in direct taxes for each dollar of gross revenue. This compares with 4.62 cents for all business corporations, including petroleum companies, and with 5.50 cents for other types of mining and manufacturing companies. These figures show that despite favorable federal income treatment the industry's direct tax burden is about the same as that of other business corporations. If sales and other excise taxes levied upon gasoline and other products were included in the 1965 compilation, the tax burden for the same 27 companies would be about 21 cents on each dollar of gross revenue. Among major consumer products only tobacco and alcohol carry a greater burden.

The fact that the industry bears a substantial tax burden is not widely known. To the contrary, the public seems to believe that the federal income tax is the only substantial burden imposed upon business. The industry's favorable income tax treatment is common knowledge. Perhaps this explains why so many who want a revised system point to the differential treatment of oil and gas as a flagrant example of alleged defects in the law.

Tax law, like all law, flows from a political process. The importance of public opinion on this process would be difficult to overemphasize. The federal income tax is a prime example of how tax law is created in the political process. The 16th Amendment to the Constitution (which made the federal income tax lawful) reflected a majority view that the wealthy class in the North and East should be required to pay a greater share of the cost of federal government. The majority apparently had found the ideal tax — one that someone else paid. As originally enacted, the law exempted about 98 percent of the people. The vast majority of people paid no income tax until about 1940. The need for tremendous tax revenue to meet the national emergency of World War II caused a substantial change in direction. A class tax became a mass tax. This is not to say that the present law makes no class distinctions. The progressive rates remind us of the original purpose. But as the rates went up it became politically feasible for Congress to make many distinctions between classes of taxpayers and types of income. And so it is that the income from growing crops may be taxed differently from the income from raising cattle. An inventor receives capital gains treatment, but not the writer or composer. Differential treatment is extended to the aged, the married and the blind. Such distinctions are almost endless. All law is, of course, based upon distinctions. The questions is whether or not a particular distinction is desirable. Since nothing hurts like the loss of money, each taxpayer has his own opinion.

The industry's problem is magnified because so many groups with diverse interests have banded together to attack the distinctions made for oil and gas producers. There is a sizeable and vocal group in this country who would eliminate all differential income tax treatment. Their announced goal is equality, a concept which has almost universal appeal. They would retain progressive rates because they say progression is not inconsistent with equality. It is assumed that as income increases so does ability to pay. In other words, without progression, some income is more equal than others. Just how they determine what rate of progression is needed to insure equality is not clear. The point is that critics of the present law are growing in number and in influence. Members of the industry are aware of the public relations problem this presents. Obviously, the law will be changed if the majority demands it.

The Federal Income Tax

Let us now review those provisions of the law that cause so much adverse publicity for the industry. The storm of protest is focused upon the depletion allowance and the deduction for intangible drilling and development costs.

We hear a lot about the depletion "loophole". The term "loophole" is generally understood to mean an ambiguity or omission in the text of a statute that permits the intent of the law to be circumvented. The fact is that percentage depletion has been a part of the statutes since 1926. The

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allowance is the greater of cost depletion or 27.5 percent of gross income from the property — but never greater than 50 percent of the taxable income from the property without taking into account the depletion allowance. Allowable depletion reduces the taxpayer's tax basis in the property, but the allowance of percentage depletion continues after basis is recovered. The deduction is criticized for being too large and for not being terminated when actual cost is recovered. Although an explanation will not convert anyone, it should be remembered that both the rate and duration of the allowance have their genesis in "discovery depletion", which became part of the law in 1918. Generally speaking, discovery depletion allowed taxpayers to deduct over the productive life of the property an amount they could have realized by selling the property shortly after the discovery. This rule was adopted for the express purpose of providing a tax incentive to encourage expansion of the industry. The policy decision was based upon the unique risks involved and the importance of oil and gas to the national welfare. The adoption of percentage depletion in 1926 was merely a pragmatic solution to the problem of determining the value of a discovery. Since 1926, percentage depletion has been extended to virtually every mineral, and the Internal Revenue Code has grown into a thick volume to accommodate differential tax treatment for numerous groups of taxpayers.

The other income tax provision that receives considerable adverse publicity is the election to deduct intangible drilling and development costs. For all practical purposes, this deduction has been a part of the law since 1913, although it was not included in the Internal Revenue Code until 1954. Every taxpayer has the option to either capitalize or deduct amounts paid for labor, fuel, repairs, hauling, supplies, and certain other intangible costs incident to and necessary for the drilling of wells and the preparation of wells for the production of oil and gas. Generally speaking, a producing well is completed when the casing, including the Christmas tree, has been installed. If the well is not completed, all the expenditures are deductible as "dry-hole" costs.

Prior to 1954, the intangible election was found in Treasury Dept. regulations. These regulations probably were promulgated to give oil and gas producers the same treatment afforded producers of hard minerals. Miners have always been allowed to deduct development costs incurred before the mine attains the productive stage.

The intangible deduction offers a twofold advantage. First, there is the immediate deduction for costs that would otherwise be capitalized. Furthermore, except for that portion of such expenditures that are directly related to physical improvements, such capitalization, generally speaking, would never generate a tax deduction. This is because of the rule that the portion of intangible costs not related to physical improvements is an additional investment in the mineral property, recoverable only through the depletion allowance. If percentage depletion is allowable, there is no additional deduction to compensate for the increase in capital cost. This technicality is important because most intangible costs are not related to physical properties. A taxpayer who had failed to make the election to deduct intangibles once made the argument that all of such costs should be treated as an addition to the capital investment in depreciable property and should be recovered through the depreciation allowance. The court held that the portion of the expenditure that was not directly related to physical improvements was recoverable only through the depletion allowance.

It is the combination of the depletion allowance and the intangible deduction that substantially reduces the federal income tax burden of the industry. Many technical problems have arisen in the application of these rules. We will mention a few that have not been resolved.

Current Federal Income Tax Problems

Not every taxpayer having a monetary interest in the successful development of an oil or gas deposit is entitled to share in the depletion allowance. Only those taxpayers who hold an "economic interest" in the mineral property qualify for the deduction. Every attempt by the Treasury Dept. and the courts to define the term "economic interest" has been only partially successful. The problem is inherent in every "carried interest" arrangement. The question may arise under processing agreements.

Another current problem, but one with a long history, involves an effort by some members of Congress to amend the income tax rules applicable to ABC transactions and carved-out production payments. Both transactions are related to the depletion allowance. The reservation of a production payment in the ABC transaction increases the realization from the sale of a mineral property. Since the gain realized from the sale is taxed it would be difficult to prove that the tax revenue is depleted. The sale of carved-out production payments can increase the depletion allowance of the seller but only at the expense of accelerating taxable income. The ultimate impact upon tax revenue would be difficult to calculate. The tax rules applicable to these transactions are firmly established and the wisdom of legislative change is doubtful.

The industry is currently confronted with a unique intangible deduction problem in connection with offshore drilling. As noted before, the option embraces certain types of expenditures that are, according to the regulations, "incident to and necessary for the drilling of wells and the preparation of wells for the production of oil and gas", including the "construction of . . . physical structures as are necessary for the drilling of wells and the preparation of wells for the production of oil and gas". The regulations further provide that the option extends to "development work done (for the operator) by contractors under any form of contract, including turnkey contract".

The Revenue Agents, faced with the onshore fabrication by independent contractors, the costly transportation and the continued use of the platform after drilling ceases, have found various reasons to disallow the deduction. The argument may be either that the platform is purchased rather than constructed under a turnkey contract, or that the platform is used primarily for production or, in any event, that the "hauling" referred to in the regulations is not applicable. It is impossible to purchase an intangible deduction. But taxpayers engaged in offshore exploration and production contend that the onshore fabrication is covered by the turnkey contract rule. Each transaction must support itself. To the argument that the platform is permanent, taxpayers cite the regulations that provide that if the taxpayer charges intangibles to capital, the portion utilized in installation and construction of physical structures must be recovered through the depreciation allowance. In other words, the intangible election clearly embraces expenditures whose life extends beyond the development stage. Taxpayers respond to the disallowance of transportation costs by citing the regulations and pointing to the absence of any limitation upon distance or amount. As taxpayers see it, the question is simply whether or not the platform is "incident to or necessary for the drilling of wells".

While it is true that the regulations were cast in modern form before the development of the offshore there is no

Recent Tax Developments

Federal Income Tax Problems

On July 26, 1968, the Treasury Dept. published proposed regulations under Sections 613 and 482 (percentage depletion on minerals and oil and gas). Several proposals have been made that would adversely affect oil and gas producers. Following is a summary of those deemed significant.

Percentage depletion would be restricted to production from gas wells and oil wells. A gas well is defined as a well that produces "natural hydrocarbon gases". An oil well produces "natural petroleum liquids". The proposed regulations specifically deny percentage depletion to oil produced from tar sands, whether or not the tar is liquefied by the injection of steam into the formation. This type of oil is not considered as a "natural petroleum liquid". Similarly, helium gas is not a "natural hydrocarbon gas". Prop. Reg. Sec. 1.613-2 (a) (1) (i).

Depletable minerals would be subject to percentage depletion at the rate applicable to the principal product being produced. For example, sulfur would be subject to depletion at 15, 23 or 27.5 percent, depending upon whether it is recovered from a metal mine, a sulfur mine or an oil well. Prop. Reg. Sec. 1.613-2 (a) (1) (ii). Although this portion of the proposed regulations is consistent with prior rulings, the logic is debatable.

Taxpayers would be required to restore percentage depletion in all instances where amounts previously received from sale of the mineral are refunded. This would overrule the decision of the 10th Circuit Court of Appeals in *Skelly Oil Co. v. U.S.*, 67-1 USTC 9417, a case that the Government has applied to the Supreme Court for certiorari. Prop. Reg. Sec. 1.613-2 (c) (8).

The point of sale, i.e., the end of the productive phase, would be changed from the "immediate vicinity of the well", or from the "premises", to the "immediate vicinity of the well head". Thus desulfurization, separation, scrubbing and absorption would be deemed to occur after production has ceased and the depletable value of the oil or gas would be reduced. This proposal is contrary to court decisions and would apparently destroy the posted price system. Prop. Reg. Sec. 1.613-3 (a). The proposed regulations would require the producer who doesn't sell his production in the immediate vicinity of the wellhead to calculate the depletable value of the oil or gas. As a general rule, this calculation would be made pursuant to the proportionate profits formula. This formula would allocate a greater portion of the amount realized from the sale to post-extractive processes and thus reduce the depletion deduction. The industry has been using the Fiske formula for years when the product is transported away from the property or converted into another product prior to sale. The Fiske formula is a work-back method wherein all costs incurred after production (including a reasonable return on investment in facilities) are deducted from the sales proceeds and the remainder is the depletable value. The proportionate profits method is something else. Prop. Reg. Sec. 1.613-3 (a) and 1.613 (d) (2).

Immediate reaction to the proposal establishing the "immediate vicinity of the well" as the cut-off point prompted the Treasury to issue Technical Information Release No. 989. Therein it is stated that the proposed regulations were not intended to treat commonly applied lease treatment processes as post-extractive activity. Further, it is stated that the processes that are commonly applied on the lease to prepare oil and gas for sale or use in crude form will continue to be treated as part of the extractive process. It is hoped that the final regulations will go at least this far. The TIR does not discuss absorption, a process that taxpayers contend should be considered as an indispensable part of production.

Costs incurred in drilling a well will no longer be reduced by receipt of bottom-hole or dry-hole contributions. Where there is production on the property this change would cause the 50 percent of net income limitation to come into play more often and thus reduce allowable depletion. Prop. Reg. Sec. 1.613-4 (c) (2).

A portion of general selling expenses of an integrated producer would be allocated to production costs and be taken into account in the 50 percent of net income limitation. The regulation is not specific and will encourage Revenue Agents to allocate substantial amounts where little, if any, should be allocated. Prop. Reg. Sec. 1.613-4 (c) (4).

Where the oil or gas is transported away from the property and finally sold to an affiliated company the value determined at the wellhead can be ignored in arriving at a fair intercompany price for the product. The producer would thus receive more or less for his product than a similarly situated nonintegrated producer. Prop. Reg. Sec. 482-2 (1) (2). Interested taxpayers were invited to comment on the proposed regulations, and hearings were held in September.

(Since this paper was presented in Houston, the Treasury has withdrawn some of the most objectionable proposed regulations, submitted new proposals and indicated that some of the other proposals would be amended before their final adoption. Thus, present indications are that the final regulations will be consistent with prior administrative practices.)

apparent reason why offshore development should not fit under the general rules. Unless the dispute is settled administratively, some of these problems may eventually be resolved by the courts.

State and Local Taxes

Members of the industry are subjected to a multitude of taxes at the state and local level. The most burdensome are property taxes, severance or production taxes, sales and use taxes and income and franchise taxes. A host of regulatory fees, excise taxes and licenses are also imposed.

All taxpayers engaged in interstate commerce pay taxes to a vast number of taxing jurisdictions. The cost of compliance alone is substantial. Many states impose a tax upon income realized from oil and gas production in other states. Members of the industry are particularly vulnerable to multistate taxation because their investments and activities are permanent and obvious. State and local tax collections are increasing at a rapid rate. In addition, the trend is to exempt a substantial number of taxpayers engaged in interstate commerce from the burden of local taxes. Generally speaking, the exemption will not apply to members of the industry. It is obvious that the remaining taxpayers must assume a greater tax burden if some of the present taxpayers are relieved. If H. R. 2158, which was recently passed by the House of Representatives, is adopted, it will reduce or eliminate state and local taxes for many taxpayers, but the cost of local government will continue to increase.

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Future Developments

Before we consider what may happen in the future it will be helpful to supplement earlier comments regarding the tax climate. At all levels of government, but especially at the federal level, tax policy is increasingly relied upon to achieve economic goals. The federal income tax law is amended to "fine tune" the economy. Despite the huge national debt and a deficit of approximately $25 billion for the fiscal year ending in 1968, the recently adopted 10 percent surtax was justified primarily as an anti-inflation measure. The use of the income tax to control the economy explains such recent developments as accelerated depreciation, investment tax credits, rate reductions and rate increases, acceleration of tax collection, taxes on foreign investment and so forth. We can expect more of this. Extremely fine tuning is required to achieve full employment on the one hand and to control inflation on the other. Recent experience tends to prove that tax changes are an effective economic tool, at least on a short-term basis.

The recently enacted surtax bill requires the President to submit a revised income tax law to Congress before 1969. Such a proposal insures that oil and gas producers will receive considerable attention. Regardless of the results of the fall elections, the depletion allowance will continue to receive adverse publicity.

The following summary is an opinion of how the industry's tax burden will develop. It is assumed that the cost of military defense remains about the same.

1. Taxes, as a percent of national gross product, will continue to increase. Taxes at all levels of government now equal about 28 percent of the national gross product. I believe that percentage will increase to 35 within 10 to 20 years.

2. State and local taxes probably will continue to increase at a higher rate than federal taxes. However, direct taxes on gasoline and other petroleum products may increase at a lesser rate.

3. The federal income tax laws will be substantially revised within the next decade. There will be increasing pressures to amend the oil depletion allowance. At first these efforts will probably be directed toward a reduction in the rate, then later toward limiting the deduction on each mineral property to either actual cost or some assumed cost.

4. Federal incentives to encourage development of shale oil reserves are expected. If the depletion allowance is substantially revised before such incentives come about, subsidies are most likely. However, if the depletion allowance retains its present form, the incentive may be a depletion allowance based upon the value of the mineral after such value has been increased by processing. ★★★

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