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Oil and Gas Tax Issues in the Tax Reform Act of 2014 and the President's FY2015 Budget Proposal

Overview and Current Law

Energy-Specific Tax Expenditures. The Joint Committee on Taxation (JCT) and the Department of the Treasury have identified a number of "tax expenditure" provisions that benefit the oil and gas sector.

Percentage Depletion. Independent producers can recover costs using percentage depletion instead of cost depletion. The deduction is generally 15% of gross income, but can be up to 25% for marginal wells. The deduction is subject to income and production limitations.

Expensing of Intangible Drilling Costs (IDCs). IDCs include expenses on items without salvage value (e.g., wages, fuel, drilling site preparations). Integrated producers must capitalize and amortize 30% of IDCs over a 5-year period, while non-integrated producers can fully expense IDCs.

Amortization of Geological and Geophysical (G&G) Expenditures. Independent producers can recover G&G expenditures over an accelerated 2-year period (major integrated producers must use a 7-year amortization period to recover G&G costs).

Expensing of Tertiary Injectants. A deduction is allowed for the cost of tertiary injectants.

Credit for Production from Marginal Wells. A $3 per barrel or $0.50 per thousand cubic feet (Mcf) credit for oil and gas produced from marginal wells. The credit is phased-out when oil and gas prices exceed certain thresholds (the credit has been phased out every year since being enacted).

Credit for Enhanced Oil Recovery (EOR). A 15% credit for eligible EOR costs. The credit is phased-out for oil prices above a set threshold.

Passive Loss Limitation Exception for Working Interests in Oil and Gas. Exception to passive activity loss rules for working interests in oil or gas property.

Generally Available Tax Expenditures. The oil and gas sector also benefits from a number of other tax provisions, where benefits are not restricted to the oil and gas sector. While there are many of this type of provision, there are a couple that are of particular interest.

Domestic Production Activities Deduction (Section 199). Section 199 provides a deduction for income from domestic production activities to reduce the effective tax rate for domestic manufacturers. The deduction is 9% for most industries, but limited to 6% for the oil and gas sector.

Last-In, First-Out (LIFO) Inventory Accounting Methods. LIFO allows taxpayers to assume that the last item that entered inventory is the first sold. A higher value of cost of goods sold reduces taxable income.

Other Tax Issues. In addition to being able to claim certain tax expenditures, the oil and gas sector is subject to special excise taxes. An 8-cent per barrel tax is currently used to finance the Oil Spill Liability Trust Fund (OSLTF). This tax is set to increase to 9-cents per barrel after 2016, before expiring at the end of 2017.

Oil and gas companies that operate overseas would also be affected by changes in U.S. taxation of multinational corporations.

Proposed Reforms

The Tax Reform Act of 2014 (TRA14) and the President's FY2015 Budget both propose to repeal a number of oil and gas related tax provisions, and would make other tax policy changes that would affect the industry (see **Table 1**).

A broad goal of tax reform is to eliminate various tax expenditures and modify other tax code provisions to generate revenues to allow for reduced tax rates. TRA14 and the President's Budget would raise additional revenues from the oil and gas sector. These revenues would offset the cost of reduced statutory tax rates. Another goal of recent tax reform proposals, including TRA14, is to better align cost recovery for tax purposes with economic depreciation to reduce economic distortions.

> The Tax Reform Act of 2014 and the President's FY2015 Budget would eliminate various tax provisions affecting the oil and gas sector in exchange for statutory rate reduction.

Several oil and gas tax provisions are related to cost recovery. Both TRA14 and the President's Budget would repeal percentage depletion, preventing taxpayers from recovering more than was invested. Cost depletion, which closer approximates economic depreciation, would be allowed. The President's Budget would also repeal expensing of IDCs, expensing of tertiary injectants, and the 2-year amortization period for G&G expenditures. TRA14 would not change these cost recovery provisions.

Table 1. Tax Reform Proposals Affecting the Oil and Gas Industry

	Tax Reform Act of 2014 (Camp's Proposal)	2014 - 2023 Revenues (billions)	President's FY2015 Budget Proposal	2015 - 2024 Revenues (billions)
Energy-Specific Tax Expenditures				
Percentage Depletion	Repeal	5.3	Repeal	13.0
Expensing of Intangible Drilling Costs (IDCs)			Repeal expensing and 5-year amortization period.	14.4
Amortization of Geological and Geophysical (G&G) Expenditures			Repeal (increase amortization period from 2 to 7 years).	3.1
Expensing of Tertiary Injectants			Repeal	0.1
Credit for Production from Marginal Wells	Repeal	0.0	Repeal	0.0
Credit for Enhanced Oil Recovery (EOR)	Repeal	0.0	Repeal	0.0
Passive Loss Limitation Exception for Working Interests in Oil and Gas	Repeal	0.1	Repeal	0.1
Generally Available Tax Expenditures				
Domestic Production Activities Deduction (Section 199)	Phased-out repeal for all industries.	115.8 (all industries)	Exclude oil and gas from definition of domestic production.	14.2
Last-In, First-Out (LIFO) Inventory Accounting Methods	Repeal. One-time income recognized over 4 years, beginning in 2019.	79.1 (all industries)	Repeal. One-time income would be recognized over 10 years.	82.7 (all industries)
Other Tax Issues				
Rules for Dual Capacity Taxpayers	Fundamental international tax reform.	n.a.	Modify rules and regulations for dual capacity taxpayers.	10.4
Superfund Tax			Impose a $0.097 per barrel excise tax on crude oil.	8.6 (all Superfund taxes)
Oil Spill Liability Trust Fund Excise Tax	Extend tax beyond 2017 and expand definition of crude oil for purposes of tax.	1.2	Increase tax by $0.01 per barrel and extend tax beyond 2017. Expand definition of crude oil for purposes of tax.	1.0

Source: The Tax Reform Act of 2014, the Joint Committee on Taxation, and Department of the Treasury.

Both TRA14 and the President's Budget would repeal the credit for EOR and the credit for production from marginal wells. These credits are predicted to be phased-out given current oil price projections. Thus, repeal of these credits would not generate revenues in the budget window.

LIFO would be repealed in both TRA14 and the President's Budget. Repealing LIFO for corporations could generate enough revenue to reduce the corporate tax rate by roughly 0.3 percentage points. TRA14 also proposes repealing the Section 199 deduction for all industries. Repealing the Section 199 deduction for corporations could pay for approximately 0.7 percentage points in corporate tax rates. (For estimates on rate reduction that could be paid for by eliminating certain tax provisions, see CRS Report RL34229, *Corporate Tax Reform: Issues for Congress*, by Jane G. Gravelle.) The President's Budget would only repeal Section 199 for fossil fuels (oil, gas, and coal), leaving the deduction in place for other industries.

TRA14 and the President's Budget would both extend the oil spill liability trust fund (OSLTF) excise tax beyond 2017. Both also propose modifying the definition of crude oil to include other sources of crudes (e.g., oil from tar sands). The President's FY2015 Budget also proposes a 1-cent increase in the tax.

Before 1996, a 9.7-cents per barrel tax on oil was collected for the Hazardous Substance Superfund Trust Fund. The President's Budget proposes reinstating the Superfund excise tax on crude oil and imported petroleum products.

The President's Budget also proposes to modify the rules and regulations for "dual capacity taxpayers," or taxpayers that are subject to a foreign levy but also receive a specific economic benefit from the foreign entity. The administration believes that, in certain cases, oil and gas companies may be claiming foreign tax credits for payments that are compensation for specific economic benefits (e.g., access to natural resources). TRA14 would also change how multinational oil and gas companies are taxed, as part of a general shift towards a "territorial" tax system. Part of this reform would include changes to the foreign tax credit system. TRA14, however, does not make changes that specifically target dual capacity taxpayers.

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