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IN FOCUS

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Oil and Gas Tax Preferences

The tax code contains a number of provisions that benefit the oil and gas sector. Some contend that these provisions should be eliminated, arguing that using energy derived from oil and gas resources is inconsistent with environmental objectives. Others view these provisions as helping a sector that is vital to the U.S. and world economy. Certain provisions are designed such that they only become available when oil prices are low, providing relief when market conditions are less favorable.

This In Focus (1) describes tax preferences for oil and gas; (2) provides information on foregone revenue associated with these tax preferences ("tax expenditures"); and (3) discusses broader tax policy issues of importance to the oil and gas sector.

Oil and Gas Tax Preferences

Several features of the income tax system reduce the tax liability of oil and gas companies. Special tax provisions include exclusions, deductions, credits, deferrals, or preferential tax rates that reduce a taxpayer's tax liability. Tax preferences for oil and gas reduce the after-tax cost of investing in oil and gas exploration and production, encouraging additional investment in this sector relative to other economic sectors.

Percentage Depletion: Depletion deductions allow taxpayers to recoup the value of capital investments in mineral property. For exhaustible resources of extractive industries, depletion cost recovery allows taxpayers to take deductions as the resource is extracted and sold. *Cost depletion* is cost recovery based on the proportion of total estimated recoverable reserves produced or sold in the year. Deductions taken for cost depletion cannot exceed the taxpayer's investment in the resource. Certain independent oil and gas producers (producers who are not retailers or refiners) may elect to claim *percentage depletion* as opposed to cost depletion. The percentage depletion allowance is 15% of gross income from the property, not to exceed (1) 100% of taxable income from the property, and (2) 65% of the taxpayer's taxable income. Oil and gas producers may claim percentage depletion on up to 1,000 barrels of average daily production (or an equivalent amount of domestic natural gas). When oil prices are low, the deduction can be up to 25% of gross income for marginal wells (generally, wells for which average daily production is less than 15 barrels of oil or barrel-of-oil equivalents or that produce only heavy oil). However, from 2001 through 2019, percentage depletion for marginal wells was limited to 15%. Percentage depletion can result in total deductions exceeding the taxpayer's investment in the well. The ability to claim percentage depletion as opposed to cost depletion provides a benefit that is considered a tax expenditure.

Expensing of Intangible Drilling Costs (IDCs): IDCs include expenses on items without salvage value (e.g., wages, fuel, and drilling site preparations). Integrated producers (producers who also have substantial refining or retail activities) must capitalize 30% of IDCs and then recover those costs over a five-year period. The remaining 70% of IDCs can be fully expensed (costs deducted in the year they are incurred). Nonintegrated producers can fully expense IDCs.

Two-Year Amortization of Geological & Geophysical (G&G) Expenditures: G&G expenditures are costs associated with determining the location and potential size of a mineral deposit. Generally, these costs are viewed as capital costs, and as such would be recovered over the same time frame as other capital costs. Most producers amortize G&G expenditures over two years. Major integrated oil companies amortize G&G expenditures over seven years. A major integrated oil company, as defined in statute, has (1) average daily worldwide production of crude oil of at least 500,000 barrels; (2) gross receipts in excess of $1 billion in its tax year ending during 2005; and (3) has at least 15% ownership interest in a crude oil refinery.

Expensing of Tertiary Injectants: Tertiary injectants are gases or fluids used as part of a tertiary recovery method to increase crude oil production. Tertiary recovery methods allow for continued production from wells nearing the end of their production lives. Taxpayers can deduct tertiary injectant expenses, other than expenses for recoverable hydrocarbon injectants, in the year costs are incurred. Expensing (deducting these costs in the year they are incurred) provides a subsidy over standard cost depletion, which might encourage firms to incur additional tertiary injectant expenses.

Credit for Production from Marginal Wells: When oil and gas prices are below certain thresholds, the marginal well credit can be claimed for producing oil and gas from marginal wells. The credit amount is $3 per barrel of qualified crude oil and 50¢ per 1,000 cubic feet of qualified natural gas (adjusted for inflation after 2005; $3.90 for oil and 65¢ for gas in 2019). A marginal well is one that is a marginal well for the purposes of claiming percentage depletion, or one that has average daily production of no more than 25 barrel-of-oil equivalents and produces at least 95% water. The credit starts phasing out if the reference price for oil exceeds $15 per barrel or natural gas exceeds $1.67 per 1,000 cubic feet (mcf) for the preceding year (adjusted for inflation after 2005; $19.52 for oil and $2.17 for gas in 2019). The credit is fully phased out if the reference price exceeds $18 per barrel or $2.00 per mcf (adjusted for inflation after 2005; $23.43 for oil and $2.60 for gas in 2019). The credit for crude oil has never been

triggered. In 2016 and 2017, and again in 2019, a partial credit (in the phaseout range) was available for natural gas. Qualified crude oil or natural gas production is limited to 1,095 barrels or barrel-of-oil equivalents, per well. The number of wells on which a taxpayer can claim the credit is not limited. The marginal well credit can be carried back for up to five years (as opposed to the one year generally allowed for other components of the general business credit).

Credit for Enhanced Oil Recovery (EOR): When oil prices are below a certain threshold, the EOR credit can be claimed for qualified EOR costs. The credit amount is 15% of qualified domestic EOR costs. The EOR credit phases out over a $6 range once oil's reference price exceeds $28 per barrel (adjusted for inflation after 1991; $48.54 in 2018). The EOR credit was fully phased out every year from 2006 through 2016. Low oil prices led to the EOR credit becoming available in 2016 and 2017. A partial credit was available for 2018, but it was fully phased out in 2019 and 2020.

Exception from Passive Loss Limitation: Generally, passive activity loss rules provide that taxpayers cannot deduct passive losses in excess of their passive activity income (passive activities are trade or business activities in which the taxpayer does not materially participate). The exemption from the passive loss limitation allows passive activity losses from any working interest in oil or gas property to be deducted against active income.

Corporate Income Tax Exemption for Publicly Traded Partnerships (PTPs): PTPs are exempt from the corporate income tax if 90% of their income is from qualified activities. Instead, PTPs are taxed like partnerships, with the owner's income passing through and being taxed at the individual level. Unlike partnerships, ownership interests are traded on financial markets like corporate stock. Qualifying income generally includes mining and natural resource income, and income related to the exploration, development, mining or production, processing, refining, transportation, storage, and marketing of any mineral or natural resource.

Oil and Gas "Tax Expenditures"

Special features of the income tax system that reduce tax collections are called "tax expenditures." The Joint Committee on Taxation (JCT) regularly publishes tax expenditure estimates—the revenue losses attributable to special income tax provisions. Tax expenditure estimates for provisions that benefit the oil and gas industry are summarized in **Table 1**.

The two largest oil and gas tax expenditures are the reductions in federal tax revenue associated with allowing taxpayers to claim percentage as opposed to cost depletion, and the provision allowing taxpayers to expense certain exploration and development costs, primarily intangible drilling costs (IDCs). For FY2020, the JCT estimated that percentage depletion reduced federal income tax revenue by $0.6 billion. Expensing of IDCs was estimated to reduce federal tax revenue by $0.5 billion. Over the five-year budget window (FY2020 through FY2024), JCT estimates that these provisions will reduce federal income tax revenue by $2.9 billion and $2.3 billion, respectively.

Table 1. Oil and Gas Tax Expenditures
(billions of dollars)

Provision	FY2020	FY2020-FY2024
Percentage depletion	0.6	2.9
Expensing of IDCs	0.5	2.3
Amortization of G&G expenditures	0.1	0.5
Expensing of tertiary injectants	-i-	-i-
Marginal well credit	-i-	-i-
EOR credit	-i-	-i-
Passive loss exception[a]	-i-	0.1
Publicly traded partnership	0.3	1.8

Source: Joint Committee on Taxation (JCT), JCX-23-20; and U.S. Department of the Treasury FY2021 Tax Expenditure estimates.
Notes: An "-i-" indicates a federal revenue loss of less than $50 million. All tax expenditure estimates are forward looking and do not reflect actual foregone revenue associated with the provision. All tax expenditure estimates are from the JCT, unless noted.

a. Estimate from the Treasury's tax expenditure publication; estimate is $10 million per year or $50 million over 5 years.

Other Tax Provisions Important to the Oil and Gas Industry

Many features of the U.S. tax system affect oil and gas industry taxpayers, beyond the more targeted tax expenditure provisions. As a capital-intensive industry, the oil and gas sector benefits from provisions that allow immediate expensing or bonus depreciation. Full expensing (100% bonus depreciation) is in effect through 2022, after which it begins to phase out (reaching 0% by 2027). Because the industry often relies on debt to finance investment, limits on net interest expense deductions might increase tax burdens for some taxpayers in the industry. Volatility in oil prices can cause oil and gas companies to experience a net operating loss (NOL). Provisions that relax NOL carryback rules or allow NOL carryforwards to be more generous can provide tax relief. The ability to use last-in, first-out (LIFO) inventory accounting methods can be beneficial to the oil and gas sector, particularly when oil prices are rising. Finally, many oil and gas companies are multinationals with cross-border operations. Thus, the tax treatment of foreign-source oil and gas income is important to U.S. oil and gas companies.

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