DESCRIPTION OF S. 828

(ENHANCED OIL AND GAS RECOVERY TAX ACT OF 1989)

Scheduled for a Hearing

Before the

SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION

of the

SENATE COMMITTEE ON FINANCE

on August 3, 1989

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

August 1, 1989

JCX-40-89

CONTENTS

	Page
INTRODUCTION	1
I. SUMMARY	2
II. DESCRIPTION OF S. 828	3
A. Enhanced Oil and Gas Recovery Depletion Allowance	3
B. Alternative Minimum Tax	6
C. Research and Development Tax Credit	8

INTRODUCTION

The Subcommittee on Energy and Agricultural Taxation of the Senate Committee on Finance has scheduled a public hearing on August 3, 1989, on S. 828, the "Enhanced Oil and Gas Recovery Tax Act of 1989" (introduced on April 18, 1989, by Senators Domenici, Boren, Dole, Nickles, Wallop, Garn, Bingaman, Johnston, McClure, and Gramm). The bill would provide tax incentives for the removal of crude oil and gas through enhanced recovery techniques and a tax credit for research and development to discover or improve tertiary recovery methods.

This document,[1] prepared by the staff of the Joint Committee on taxation, provides a description of S. 828. The first part of the document is a summary. The second part is a description of the bill, including present law, effective dates, and related provisions of the Administration proposal for tax incentives for enhanced oil and gas recovery.

---

1 This document may be cited as follows: Joint Committee on Taxation, Description of S. 828 (Enhanced Oil and Gas Recovery Tax Act of 1989) (JCX-40-89), August 1, 1989.

I. SUMMARY

S. 828--Enhanced Oil and Gas Recovery Tax Act of 1989

Senators Domenici, Boren, Dole, Nickles, Wallop, Garn, Bingaman, Johnston, McClure, and Gramm

The bill would increase the percentage depletion rate for domestic oil and gas recovered through enhanced recovery techniques to 27.5 percent, phased-down as the price of crude oil increases above $30 per barrel adjusted for inflation. The bill would also increase the net income limitation on this oil and gas from 50 percent to 100 percent. The alternative minimum tax preferences for percentage depletion and intangible drilling costs (IDCs) would not apply to the deductions attributable to this oil and gas. Further, a 10-percent research and development tax credit would apply to research to discover or improve tertiary recovery methods.

Administration Proposal[2]

The Administration proposal would replace the 50-percent net income limitation with a limitation based on 100 percent of net income in the case of all percentage depletion allowable under the Code. The proposal would allow percentage depletion to be claimed by a transferee of proven oil- or gas-producing property. Further, the proposal would eliminate 80 percent of the present law tax preference attributable to IDCs incurred by independent producers for exploratory drilling. The proposal would also provide a 10-percent tax credit for certain projects utilizing tertiary enhanced recovery techniques.

---

[2] As contained in President Bush's budget proposal for fiscal year 1990, submitted to the Congress on February 9, 1989.

II. DESCRIPTION OF S. 828

A. Enhanced Oil and Gas Recovery Depletion Allowance

Present Law

General rules

Certain costs incurred prior to drilling an oil- or gas-producing property are recovered through depletion deductions. Generally, these include costs of acquiring the lease or other interest in the property, and geological and geophysical costs. Depletion is available to any person having an economic interest in a producing property (including a royalty interest, working interest, overriding royalty interest, or net profits interest).

Depletion is computed using whichever of two methods results in a higher deduction: cost depletion or percentage depletion (however, the deduction for percentage depletion is limited to certain taxpayers as discussed below).

Under the cost depletion method, the taxpayer deducts that portion of the adjusted basis of the property which is equal to the ratio of units sold from that property during the taxable year to the estimated number of units remaining to be recovered at the beginning of the taxable year. The amount recovered under cost depletion cannot exceed the taxpayer's basis in the property.

Under the percentage depletion method, 15 percent of the taxpayer's gross income from an oil- or gas-producing property is allowed as a deduction in each taxable year. The amount deducted cannot exceed 50 percent of the taxable income from the property for the taxable year, computed without regard to the depletion deduction (the "net income limitation"). Additionally, the allowance for percentage depletion cannot exceed 65 percent of the taxpayer's overall taxable income, determined before such deduction and adjusted for certain loss carrybacks and trust distributions (the "taxable income limitation").[3] Because percentage depletion is computed without regard to the taxpayer's basis in a property, cumulative depletion deductions may exceed the amount expended by the taxpayer to acquire or develop the property.

---

[3] An amount disallowed as a result of this rule can be carried forward as a percentage depletion deduction in the following taxable year, subject to the 65-percent taxable income limitation for that year.

Limitation of deduction for percentage depletion to independent producers, etc.

Under present law, the deduction for percentage depletion for oil and gas properties is limited to independent producers and royalty owners (as opposed to integrated oil companies), for up to 1,000 barrels of average daily domestic crude oil production, or an equivalent amount of domestic natural gas. For producers of both crude oil and natural gas, this limitation applies on a combined basis.[4]

For purposes of percentage depletion, an independent producer is any producer who is not a "retailer" or "refiner." A retailer is any person who directly, or through a related person, sells oil or natural gas (or any product derived therefrom) (1) through any retail outlet operated by the taxpayer or a related person, or (2) to any person obligated to market or distribute such oil or natural gas (or product derived therefrom) under the name of the taxpayer or the related person. Bulk sales to commercial or industrial users, and bulk sales of aviation fuel to the Department of Defense, are excluded for this purpose. Furthermore, a person is not a retailer within the meaning of this provision if the combined gross receipts of that person and all related persons from the retail sale of oil and natural gas (or any product derived therefrom), do not exceed $5 million for the taxable year.

A refiner is any person who directly, or through a related person, engages in the refining of crude oil, but only if such taxpayer and related person have refinery runs in excess of 50,000 barrels on any day during the taxable year.

Percentage depletion is not allowed with respect to the transferee of a transferred proven oil- or gas-producing property. Generally, a proven property is a property that, at the time of transfer, has had its principal value demonstrated by prospecting, exploration, or discovery work.

Explanation of the Bill

Depletion rate for enhanced recovery

S. 828 would provide a 27.5-percent depletion rate with respect to the production of domestic incremental tertiary crude oil and natural gas during the enhanced recovery period. This deduction would be available to all taxpayers (including independent and integrated producers) for an unlimited amount of production. Under the bill, the 27.5-percent rate would be phased-down to 15 percent by one percentage point for every

---

[4] Certain regulated natural gas, natural gas sold under a fixed contract, and natural gas from geopressed brine is exempt from the 1,000-barrel-per-day limitation.

dollar that the taxpayer's average removal price of oil for the calendar year exceeds $30 per barrel.[5] Under the bill, a taxpayer's average annual removal price for any calendar year would be computed by dividing the aggregate dollar amount for which domestic crude oil was sold by the taxpayer during the calendar year, by the taxpayer's aggregate production of such oil.[6]

For purposes of the bill, incremental tertiary oil and gas includes incremental tertiary oil as defined for prior law windfall profit tax purposes (Code sec. 4993(a), using the current Energy Department (DOE) regulations). Under DOE regulations, tertiary recovery techniques include miscible fluid displacement, steam driven injection, microemulsion or micellar emulsion flooding, in situ combustion, polymer augmented water flooding, cyclic steam injection, alkaline or caustic flooding, carbon dioxide augmented water flooding, and immiscible carbon dioxide displacement. Reservoir improvements (including infill patterns and pattern conformance) incident to a qualified tertiary recovery project would be treated as a project which is otherwise a qualified tertiary project. Oil and gas produced from nonhydrocarbon gas flooding, tight formation gas, and certain tight formation oil would also qualify as incremental tertiary oil and gas under the bill.

The enhanced recovery period is a period, as determined by a schedule to be published by the Secretary of the Treasury, based on the average period for a project to recover the expenses of the type of project involved for that geographic region. The enhanced recovery period would not end earlier than six months after the publication of the schedule by the Secretary.

The bill would not amend present law treatment applicable to the deduction for percentage depletion by independent producers and royalty owners for property other than enhanced tertiary recovery property. Additionally, the bill generally would not treat barrels of enhanced domestic tertiary oil and gas produced by an independent producer or royalty owner as barrels of oil or gas produced by such person in applying the 1,000-barrel-per-day limitation on such deduction.

---

5 The $30 per barrel threshold will be adjusted annually for inflation, as measured by the GNP implicit price deflator, beginning in 1991.

6 As drafted, the bill contains a technical error in the definition of the term "average annual removal price," by defining such term as the aggregate production of crude oil, divided by the aggregate receipts from the sale of such oil.

Net income limitation

In addition, the bill would increase the net income limitation from 50 percent to 100 percent of net income in the case of depletable property which produces domestic incremental tertiary crude oil or natural gas during the enhanced recovery period.

Effective date

The provision would be effective for oil and gas production after the date of enactment and before January 1, 2010. The provision would apply after December 31, 1999, only to production from a project begun before January 1, 2000. Expansion of a project begun on or after the date of enactment would be treated as a separate project. In the case of production from a project begun on or before the date of enactment, the rate for percentage depletion would be 18 percent rather than 27.5 percent.

Administration Proposal

The Administration proposal would amend present-law treatment of depletion in two respects. First, the proposal would eliminate the 50-percent net income limitation on the deduction for percentage depletion generally, and in its place impose a 100-percent net income limitation. Second, the proposal would allow percentage depletion to be claimed by independent producers and royalty owners on transferred proven oil- or gas-producing property.

B. Alternative Minimum Tax

Present Law

Depletion

Under present law, the deduction for depletion is an item of tax preference for purposes of the individual and corporate alternative minimum taxes, to the extent that the depletion deduction constitutes excess percentage depletion. Excess percentage depletion is defined as the excess of the taxpayer's allowable depletion deduction for the taxable year with respect to a particular oil- or gas-producing property over its adjusted basis in such property at the end of the year (prior to adjusting the basis for current year allowable depletion).[7]

---

[7] Additionally for this purpose, the adjusted basis does not include intangible drilling costs attributable to the property that have been previously deducted by the taxpayer.

Intangible drilling and development costs

Under present law, the deduction for intangible drilling and development costs (IDCs) on successful oil and gas wells is an item of tax preference for purposes of the individual and corporate alternative minimum taxes, to the extent that the taxpayer's excess IDCs exceed 65 percent of its net income from oil and gas properties. (Geothermal properties are treated in a similar manner.) Excess IDCs are defined generally as (1) IDC deductions (attributable to successful wells) for the taxable year, minus (2) the amount that would have been deductible in that year had the IDCs been capitalized and recovered over a 10-year, straight line amortization period. At the election of the operator, the cost depletion method may be substituted for the 10-year amortization schedule in determining the amount of tax preference.[8]

IDCs are not treated as an item of tax preference if the taxpayer elects to amortize such costs over a 10-year period.

Explanation of the Bill

Depletion and IDCs as tax preference items

S. 828 would repeal the treatment of excess depletion and excess IDCs as items of tax preference with respect to domestic properties that produce oil and gas through the use of enhanced tertiary recovery techniques if the average annual removal price of oil for the taxable year is less than $30 per barrel (adjusted for inflation beginning in 1991).[9]

Effective date

The provision would be effective with respect to production, or costs paid or incurred, after the date of enactment and before January 1, 2010. Additionally, the provision would not apply to production, or costs paid or incurred, after December 31, 1999, unless such production or costs are attributable to a project begun before January 1, 2000.

---

[8] In addition, for taxable years beginning after December 31, 1989, corporations are subject to an alternative minimum tax adjustment for adjusted current earnings. In computing adjusted current earnings, IDCs on successful wells must be amortized over the longer of 60 months or the period used by the corporation for financial accounting purposes.

[9] See discussion of oil and gas recovered through enhanced tertiary recovery techniques (A., above).

Administration Proposal

The Administration proposal would eliminate 80 percent of the present-law minimum tax preference for IDCs attributable to exploratory drilling incurred by independent producers.

C. Research and Development Tax Credit

Present Law

Present law provides for the allowance of a tax credit with respect to certain costs incurred by taxpayers for increasing qualified research activities (the "R&D credit"). The amount of the credit is equal to 20 percent of the excess of current qualified research expenses over the average of such expenses incurred by the taxpayer over the preceding three taxable years.[10] Also, a 20-percent credit is allowed for certain costs incurred domestically for an original investigation for the advancement of scientific knowledge which does not have a specific commercial objective.

Research which qualifies for the R&D credit includes research which is undertaken for the purpose of discovering information which is technological in nature, and the application of which is intended to be useful in the development of a new or improved business component of the taxpayer. Under present law, qualified research can include certain costs incurred with respect to the development of new methods for extracting mineral deposits, including tertiary recovery methods.[11]

Explanation of the Bill

Research credit for tertiary recovery methods

S. 828 would treat any research to discover or improve one or more tertiary recovery methods for domestic crude oil or natural gas as research which qualifies for the R&D credit if the research is based on accepted principles of engineering. The bill would apply the credit for tertiary recovery research separately from the credit for other R&D, including the determination of the three-year base period average applicable to such research. With respect to such research, the credit would be at a 10-percent rate.[12]

---

[10] However, in no event can the three-year base period average be less than one-half of the current qualified research expenses.

[11] See, for example, Rev. Rul. 74-67, 1974-1 C.B. 63.

[12] Under the bill, it is unclear whether such research that (Footnote continued)

Effective date

The provision would be effective for amounts paid or incurred after the date of enactment, and before January 1, 2010. Amounts paid or incurred before the date of enactment would be taken into consideration in determining base period research expenses.

Administration Proposal

The Administration proposal would provide a 10-percent tax credit for all capital expenditures on projects that represent the initial application of tertiary enhanced recovery techniques to a property. Additionally, with respect to the R&D credit, the Administration proposal would (1) compute the base period amount as an amount equal to 102 percent of the taxpayer's average qualified research expenses for the years 1983 through 1987, indexed for inflation, and (2) allow for an optional credit, in addition to the regular credit, equal to 7 percent of the current year's qualified research expenses in excess of 75 percent of the base period amount.

---

[12](continued)
would qualify for the R&D credit under present law would be creditable at the present-law rate of 20 percent instead of the 10-percent rate as provided in the bill.