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RE: Comments: Manufacturing Tax Reform Working Group

On behalf of the American Petroleum Institute (API), the only national trade association that represents all aspects of America's oil and natural gas industry, we applaud the efforts of the House Ways & Means Committee and the Manufacturing Tax Reform Working Group to understand the tax issues of concern to our industry.

Currently, America's oil and natural gas industry supports 9.2 million jobs in the United States and 7.7 percent of our nation's Gross Domestic Product. Every day we deliver on average around \$86 million to federal coffers in rents, royalties, bonus payments and income tax payments. Our effective tax rate – averaged over the years 2006 through 2011 – is 44.3 percent, well above the 35 percent general corporate tax rate.

Given the size and scope of our industry in the US, we understand that any fundamental changes to the corporate tax code will impact our members, and the millions of American jobs that rely upon a vibrant energy and manufacturing sector.

In an effort to help lawmakers better understand the industry, enclosed are the following documents:

- API's general tax reform principles,
- Issue one-pagers pertaining to LIFO and Section 199, and
- Paper on the legislative history and importance of IDC with executive summary.

We hope you find these documents helpful as you work through these important issues. If you have any additional questions, please feel free to contact myself, and Stephen Comstock, Director of Tax & Accounting Policy at comstocks@api.org.

Sincerely,

A handwritten signature in black ink that reads "Brian M Johnson". The signature is stylized and cursive.

Brian M Johnson

API Tax Reform Principles

Introduction

The goal of any well-structured tax system should be to raise revenue in a way that does the least amount of economic harm, while encouraging domestic investment and job creation, and allowing taxpayers to compete internationally for new opportunities. To achieve these goals, tax rules should be non-discriminatory among industries and should provide a level playing field for taxpayers engaged in similar activities.

Recently, concerns have grown about the current U.S. tax system, (i.e., that the rules limit U.S. competitiveness in an increasingly global economy), leading to calls for tax reform. Any tax reform should be based on sound, transparent policies, and tax rates should be lowered to support a tax structure that promotes investment and is competitive with other major trading partners.

We recognize that tax reform will be a substantial undertaking and will significantly impact how businesses look at the economics of their investments. We also highlight that any new tax rules addressing America's oil and natural gas industry could directly impact the amount of energy that is produced and supplied to the economy. Therefore, in order to help frame the debate on how to approach tax reform with respect to energy, we raise the following considerations.

Domestic Pro-growth/Pro-job Considerations

The U.S. oil and natural gas industry currently supports 9.2 million jobs in the economy, over 2 million of which are supported by the refining and petrochemical segments. The industry as a whole accounts for 7.8 percent of the nation's Gross Domestic Product (GDP). One of the main reasons for this significant impact is the size and scope of the domestic capital investments which are necessary to produce and refine the energy demanded by U.S. consumers. For example, according to the U.S. Census Bureau, oil and natural gas extraction, refining and supporting activities accounted for over 13 percent of all new structure and equipment investment in 2010 – over \$100 billion¹. In addition, the top 50 exploration and production companies spent another \$100 billion on acquiring access to various U.S. properties for future development.²

Since oil and natural gas reserves are depleting resources, these substantial investments must be made on a recurring and continuous basis for the industry to maintain and continue to grow production and refining in the U.S., and to meet the economy's energy demands. Because investment needs to occur on a continuous basis, a stable and predictable stream of cash flow is critical to the economics supporting domestic projects. Given the risks inherent in the oil and gas business, and the level of the expenditures required, these costs must be recovered quickly in order for the industry to continue to reinvest in the next project or to hire new employees. The industry's oil and natural gas exploration and drilling investment analysis is very similar to the investments made by companies with a heavy concentration of research and development, where the technologies of tomorrow must be funded by the successes of today.

Therefore, any new pro-growth, pro-jobs tax regime must incorporate competitive and robust capital cost recovery provisions that take both risk and economic development goals into account. While a lower statutory rate will likely impact the after tax cash flow of all investments, we have found that in our industry there is not an exact "trade-off" between a lower corporate tax rate and the lengthening of cost recovery periods. We would

¹ 2010 Annual Capital Expenditures Survey, Table 4a, U.S. Census Bureau (released February 8, 2012). http://www.census.gov/econ/aces/xls/2010/full_report.html

² US oil and gas E&P benchmark study, 2010. <http://www.ey.com/US/en/Industries/Oil---Gas/US-oil-and-gas-E-P-benchmark-study>

API Tax Reform Principles (cont.)

note that, economy wide, a reduced tax rate can benefit existing investments (such as production from a factory already in place), but that lower rate may not provide for the continued after tax cash flow necessary to drive new investments and projected reinvestments. This is especially true if the capital cost recovery rules are significantly changed in the tax reform process.

Given the size of the oil and natural gas industry, we understand it will be impacted by any tax reform effort. But we believe it is imperative that any new tax system not specifically target any one industry over another for additional tax benefits, burdens, or costs. Using the tax code to pick winners and losers should be avoided. Specifically, within the energy sector we believe that any new tax system should not favor one form of energy at the expense of others or one type of taxpayer at the expense of others, particularly those engaged in the same activities.³ In a growing economy, all forms of energy production should be encouraged, but efforts to favor one form of energy over others should be avoided.

International Tax Reform – Territorial

We recognize that the taxation of foreign operations by a home country is a very complex area to address in tax reform. However, the industry's main focus in reforming international tax provisions is fairly simple: rules ensuring that foreign source operating income of U.S. based companies is not subject to double taxation are essential for supporting the competitiveness of U.S. companies internationally.

As an extractive industry, we must operate where the resource is located rather than where the tax rate is the lowest. In fact, the industry pays substantial income taxes on its foreign operations, which often causes the industry's effective tax rate to be over 40 percent. The industry is currently able to repatriate a substantial amount of international cash back to the U.S. economy⁴ under the foreign tax credit mechanism, which allows U.S. taxes on foreign sourced income to be offset by foreign taxes paid on those operations. This tax system generally alleviates the double taxation concerns.

Therefore, in general, the industry can support a territorial system provided it is competitive with the tax laws of the other major developed countries and allows U.S. based oil and natural gas companies to compete internationally with non U.S. oil and natural gas companies. For example, any move to a territorial system must insure that all active operating and related income would qualify for exemption, and that all industry specific tax restrictions are eliminated. Of course, until such time as a new system is implemented, a fully functioning and competitive foreign tax credit system must remain in place.

Additional Comments & Considerations

The industry recognizes the value of a lower corporate tax rate and supports movement in that direction. However, further base broadening measures used to support a lower tax rate could significantly impact the cash flow for domestic projects. As such, we are concerned that such measures could result in less domestic energy investment and ultimately undermine the goal of pro-growth tax reform. We would encourage the development of proposals that can achieve both of these objectives—lower rates and robust pro-growth capital cost recovery mechanisms.

³ The U.S. oil and natural gas industry is the only industry in which the tax rules apply differently to significant members of that industry based on size (or involvement in additional business lines such as retail marketing of gasoline or refining). Pro-growth tax reform and an efficient tax system require that tax provisions be nondiscriminatory and evenly applied among taxpayers within an industry.

⁴ Over \$70 billion was repatriated by the industry in 2009 according to IRS data.

API Tax Reform Principles (cont.)

Any new tax regime will be difficult for businesses to immediately adopt. Therefore, we support the development and implementation of fair and equitable transition rules. Establishing transition rules that provide adequate time for implementation and that take into account prior reliance on the current tax code as manifested in existing agreements, practices, and other requirements is essential for the success of any new tax system.

Finally, we recognize the difficulty in tackling truly comprehensive tax reform. Subject to addressing the above tax reform principles and considerations, phased corporate or individual tax reform could be a way to facilitate the process for broad tax reform. However, in all cases, targeted, isolated, or piecemeal changes should be avoided.

Repealing LIFO accounting will hurt U.S. businesses, stifling job creation and energy production

Background

The tax law requires taxpayers with inventory to value their ending balances in order to determine which costs are included in the cost of goods sold over the course of the year. One of the main methods for valuing ending inventory is the LIFO (last in/first out) accounting method. LIFO accounting is based on the assumption that the last goods brought into inventory are the first goods sold. Therefore the cost of the last goods manufactured or purchased are associated with the goods sold to generate current revenue. This allows for a clear reflection of income as current costs are matched with current income – especially for taxpayers dependent upon commodities as part of their business operations.

LIFO is a well-accepted accounting method used by many American industries and has been approved by the IRS as an appropriate way to value ending inventories since the 1930s. It is not some “gimmick” or “loophole” to inappropriately lower one’s taxable income. A taxpayer employing LIFO to value ending inventories for tax purposes must also follow this method to calculate their book income. As a result, there is limited impetus for taxpayers to try and exploit or arbitrage the system - efforts to lower tax income are tied to book income results for shareholders and bondholders.

Impact of Repeal

Repealing LIFO would result in a significant impact on any taxpayer currently employing that method to value their ending inventories. The impact stems from the fact that it deems a reduction in previously reported cost of sales to have occurred and gains to be recognized without any real profit being generated. Therefore, repeal of LIFO accounting would result in a significant up-front tax burden for businesses associated with a *deemed* retroactive reduction of cost of sales. No actual transaction would take place to generate operational cash. As a result, this proposal would place significant cash constraints on taxpayers employing the LIFO methodology. And the expected cash drain would certainly be felt. Taxpayers would need to generate funds to pay the expected tax that would have to come from existing capital reserves that would have otherwise been invested in jobs, new investment or business expansion.

Like taxpayers in other industries, many oil and gas companies with refining operations properly elected to use LIFO many years ago to value and account for their inventory. Since the industry continued to grow and needed to purchase a volatile commodity as a raw material, the LIFO was the best method to allow current costs to offset income for the current year. Congress and the Administration have suggested that LIFO constitutes some type of tax abuse, but no specific tax abuse problem or other policy reason for changing the LIFO rules has been credibly advanced. Again, LIFO is not a gimmick. It is simply an accounting method that clearly reflects taxable income for companies that anticipate inflation or rising prices.

Repealing the Section 199 Manufacturing Deduction for Oil and Gas Companies Puts Jobs at Risk

In 2004, Congress enacted the Section 199 deduction which makes deductible a portion of income derived from domestic production, manufacturing and extractive activities to encourage job expansion and creation in the US.

For most U.S. manufacturers, the current deduction is 9% of their net income derived from qualified domestic production activities – this is approximately equal to a three-percentage point reduction (35% to 32%) in the corporate income tax rate for qualified domestic income. However, recent legislation has already penalized the US oil and gas industry by freezing them at 6%.

Now, proposals to eliminate Sec. 199 altogether for only the oil and gas industry will have the harmful effect of hurting American energy workers and their contributions to our economic recovery. Congress should support the Section 199 deduction for oil and gas operations because:

- Repeal of the deduction would threaten some of the 9.2 million jobs supported by the US oil and gas industry. The average salary of an extraction and production job (including petroleum geologists, refinery workers, rig builders, accountants, chemical engineers, environmental technicians and many other categories of workers) directly supported by the oil and gas industry is \$52,000 *higher* than the average salary in the US.
- The purpose of Sec. 199 was to encourage domestic job creation among US manufacturers and producers. From 2004-2007, the oil and natural gas industry was responsible for nearly 2 million additional domestic jobs.
- According to a Wood Mackenzie study, the repeal of Sec 199 and other proposed tax changes could place as much as 600,000 boe/d at risk in 2011 and by 2017, more than 10% of US oil and gas productive capacity could be compromised. This volume accounts for approximately \$10-17 billion in direct upstream investment per year. These proposed tax changes for only the US oil and gas industry could also place thousands of jobs at risk:
 - 58,800 direct, indirect and induced US jobs are at risk in the year implemented
 - 165,000 total direct, indirect and induced US jobs at risk by 2020
 - The Rocky Mountain, on-shore Gulf Coast, and mid-Continent regions of the US have the highest potential jobs at risk
- Further, since the inception of Sec. 199, additional jobs have led to increased US production which strengthens our energy security. Despite declining reserves and access restrictions, according to DOE:
 - Oil production has increased 5.6% between 2005 and May 2010
 - Federal offshore Gulf of Mexico production increased 22%
 - North Dakota production, including the Bakken oil reserve region, has increased 122%, and
 - Domestic natural gas production has increased 16%
- Eliminating the deduction would force the industry to pay more in taxes, creating special challenges for financing high-cost domestic projects. Paying billions more in income taxes would make it harder to find the capital to build costly projects such as a major refinery expansion, and would be harmful to our domestic energy security and continued job creation.

For more information, visit API.org

Summary Hand-Out of Intangible Drilling Cost (IDC) Deduction

- Intangible drilling costs (otherwise known as “IDC”) include charges for the wages, fuel, repairs, hauling and other non-salvageable expenses incident to and necessary for the drilling of wells or the preparation of wells for the production of oil or gas.
- These costs usually represent at least 60 to 80 percent of the cost of the well during the initial exploration and development process.
- The election to recover drilling costs quickly allows them to be treated like all other business’ operating costs. Drilling wells to meet production demands is necessary for oil and natural gas companies to maintain output volumes on inherently depleting reserves.
- This treatment does not constitute a “subsidy,” nor is it a special credit towards the industry, since it does not reduce actual tax liability over the life of any project.
- Further, the current treatment of IDC costs promotes sound domestic energy policy and is necessary to maintain and ensure America’s energy security.
- The timing of these deductions has played a crucial role in advances in technology, spurred transformations in the US economy in general and America’s energy sector in particular, and is not unique to the energy sector within the tax code.
- The research and experimental cost deduction (Sec 174) and the intangible drilling and development cost deductions (Sec 263(c)) have identical policy goals: to promote innovation, foster development of new products and resources, and promote economic growth.
- All businesses deduct their costs of earning income—IDC cost recovery facilitates reinvestment in the next breakthrough technology or additional employees.
- Investment intensive businesses operate under a regime where cash flow is very important and overly simplified tax assumptions do not account for the complicated connection between business decisions and the tax law.
- Rates of return are directly influenced by the timing of cash outflows and inflows related to the project.
- Significantly delaying the timing of the tax deductibility of drilling costs reduces the discounted cash flow and rate of return values such projects will generate, and thus many projects will no longer meet investment rate criteria.
- Therefore, a lower corporate income tax rate does not offset the negative impact on cash flow should the IDC deduction be eliminated/extended.

Executive Summary - Existing rules are correct tax and energy policy for America

After decades of accepting the energy dependency of the United States, we have come to an amazing position of seeing the U.S move toward energy *in*dependence in the coming years. This is largely due to enhanced technology that helps energy companies identify meaningful reservoirs, locate and drill wells on the most efficient sites, and develop (and produce from) the wells in a way that is both environmentally responsible and recovers as much of the reservoir as possible. This enhanced technology has been developed through the continuous testing of drilling activities and companies incurring substantial amounts of drilling costs.

Reaching America's goal of energy independence is not guaranteed. It will require continued investment and innovation. With the right policies, the industry will continue to drill the wells and develop the technology needed to keep us on the right path. With the wrong policies, the march to energy independence could be stopped dead in its tracks. This paper discusses tax policy. Specifically, this paper explains why permitting a tax deduction for the operating expenses associated with drilling a well is consistent with standard tax policy, and why deviating from this standard treatment puts at risk the future investment and innovation required for keeping the goal of energy independence within reach.

An onshore well's total cost can be several million dollars—substantially more (e.g., in the hundreds of millions) for offshore wells. Given that companies drill hundreds of wells a year, the amount spent on drilling costs to find new energy sources adds up to billions of dollars. Clearly, the energy industry is a capital intensive business and an increase in the costs of, and reduction of cash available for, drilling can be devastating. This can be seen historically when natural gas and oil prices were so low that energy companies investment returns and available cash were inadequate to fully implement their drilling programs. It also can be seen today, as very low natural gas prices are beginning to impact the pace of drilling in the U.S.

Intangible drilling costs (otherwise known as "IDC") include charges for the wages, fuel, repairs, hauling and other non-salvageable expenses incident to and necessary for the drilling of wells or the preparation of wells for the production of oil or gas. These costs usually represent 60 to 80 percent of the cost of the well during the initial exploration and development process.

The correct tax treatment for such costs turns precisely on the fact that, as the government has recognized from the beginning of the income tax code, such costs do not "...necessarily enter into and form a part of the capital invested...", because they do not themselves provide any "salvage value" to the taxpayer with respect to the property. Hence, IDCs are properly treated as all other operating costs are treated, deductible business operating expenses in the year of the expenditure. Far from being "special" tax treatment, current expensing is the correct treatment of IDCs under normalized tax policy.

This tax treatment is also consistent with sound domestic energy policy. Further restrictions on expensing intangible drilling costs would make domestic exploration more expensive, discouraging new domestic oil and natural gas exploration and undermining America's energy security. New investment in domestic energy is critical to meeting future energy demand, boosting U.S. energy security, protecting jobs and creating new ones.

What follows is a history of IDC which supports why the current tax rules provide the correct technical treatment for such costs and why this provision is vitally important to the day-to-day operations of all oil and natural gas extraction.

History of IDC - The Beginnings—Administrative conclusions that IDCs are operating costs

The lore is that IDCs have been allowed since the time of the Tax Act of 1913 based upon the language of the Tax Act of 1913, which provides:

*That in computing net income for the purpose of the normal tax there shall be allowed as deductions: First, the necessary expenses actually paid in carrying on any business, not including personal, living, or family expenses; . . .*⁵

However, the first indications of any administrative allowance of the deduction appear to be contained in Regulations 33, “Law and Regulations Relative to the Tax on Income of Individuals, Corporations, Joint Stock Companies, Associations and Insurance Companies Imposed by Section 2, Act of October 3, 1913,” issued by the IRS on January 5, 1914. Regulations 33, Article 114 provides under the rubric “General Expenses,” which are included in deductible ordinary and necessary expenses, “Expenses of operation and maintenance shall include all expenditures for material, labor, fuel, and other items entering the cost of the cost of goods sold or inventoried at the end of the year, and all other expenses incurred in the operation of the business except such as are required by the act to be segregated in the return.”

Questions arose with respect to the proper tax treatment of a number of costs associated with the drilling of oil and gas wells and the production therefrom, and in a February 8, 1917, pronouncement, the Internal Revenue Service and the Treasury Department clarified the proper tax treatment of a number of such costs, including depletion, depreciation, and certain expenses of drilling wells, under the Revenue Act of September 8, 1916. In respect of the latter, the government stated the following:

The incidental expenses of drilling wells, that is, such expenses as are paid for wages, fuel, repairs, etc., which do not necessarily enter into and form a part of the capital invested or property account, may, at the option of the individual or corporation owning and operating the property, be charged to property account subject to depreciation or be deducted from gross income as an operating expense..

Regulations 33 were revised in 1918 to cover the enactment of the Revenue Act of 1916 and the Act of October 3, 1917. Sections 5 and 12 of the Revenue Act of September 8, 1916, amended by the 1917 Act, first authorized a depletion allowance to individuals and corporations operating oil or gas properties. Sections 502 and 503 of the revised Regulations 33 provided an option to either deduct currently or capitalize and recover through depletion the expense of drilling wells:

In the case of a lessee, the capital thus to be returned is the amount paid in cash or its equivalent, as a bonus or otherwise by the lessee for the lease, plus also all expenses incurred in developing the property (exclusive of physical property) prior to the receipt of income therefrom sufficient to meet all deductible

⁵ Tax Act of 1913, Section II (B)

expenses, after which time as to both owner and lessee, such incidental expenses as are paid for wages, fuel, repairs, hauling, etc., in connection with the drilling of wells and further development of the property, may, at the option of the operator, be deducted as an operating expense or charged to capital account⁶.

Courts also recognized the option to expense these costs under these regulations. In the early tax case, *Shaffer v. Commissioner*⁷, the taxpayer had capitalized drilling costs for the tax years 1913-1915, but elected to expense similar costs for the period 1916-1918. The taxpayer sold the mineral properties in 1919 and sought to increase the basis in the properties by the amount expensed in the later years. In denying the taxpayer's claim, the court held that the regulations had given the taxpayer the option to expense which was validly claimed and that the taxpayer was bound by that election.

Regulations issued in 1919 combined the oil and natural gas expense recovery provisions into a more succinct election:

Such incidental expenses as are paid for wages, fuel, repairs, hauling, etc., in connection with the exploration of the property, drilling of wells, building of pipe lines, and development of the property may at the option of the taxpayer be deducted as an operating expense or charged to the capital account returnable through depletion.

This language was retained in the regulations until in 1933, when the expression "intangible drilling and development costs" was first used in reference to the allowance of the deduction for expenditures for "wages, fuel, repairs, hauling, supplies, etc. incident to and necessary for the drilling of wells and the preparation of wells for the production of oil or gas. . . ." Furthermore, the regulations gave more detailed examples of the costs the Treasury Department contemplated as being deductible under the regulations and described them as not having a salvage value⁸.

Regulations adopted under the 1939 Code in 1943 limited the election for taxable years beginning after December 31, 1942, such that the option to deduct intangible drilling costs was limited to those incurred by the operator, that is, one who holds a working or operating interest in any tract or parcel of land either as a fee owner or under a lease or any other form of contract granting working or operating rights. The concept of costs incurred by an operator, or the "lessee", of an oil and natural gas property, is significant. In most cases, the operator has only a leasehold right to produce the minerals, and all ownership rights in the property revert to the fee owner when production ceases. In addition, the operator generally has the obligation to remove certain production equipment, and to plug and secure any wells drilled. Thus, the total costs of "drilling" a hole, including the restoration obligations, taken on by an operator are distinguishable from the costs of permanently improving property by an owner of that property. This distinction provides one of the important factual bases

⁶ Section 502 of the revised Regulations 33, 1918

⁷ 29 BTA 1315 (1934).

⁸ Regulations 77, Art. 236 Charges to capital and to expense in the case of oil and gas wells. – (a)(1): ... *Examples of items to which this option applies are, all amounts paid for labor, fuel, repairs, hauling, and supplies, or any of them, which are used (A) in the drilling, shooting, and cleaning of wells; (B) in such clearing of ground, draining, roadmaking, surveying, and geological work as are necessary in preparation for the drilling of wells; and (C) in the construction of such derricks, tanks, pipe lines, and other physical structures as are necessary for the drilling of wells and the preparation of wells for the production of oil or gas. In general, this option applies only to expenditures for those drilling and developing items which in themselves do not have a salvage value. For the purpose of this option labor, fuel, repairs, hauling, supplies, etc., are not considered as having a salvage value, even though used in connection with the installation of physical property which has a salvage value*

for treating such costs that do not produce a “salvageable” asset as more akin to operating costs than to permanent improvements to property benefitting the investor.

Additionally, one never knows the volumes of the production that the “asset” will produce when an oil or natural gas well is drilled and completed. The manufacturing plant owner can establish the rated capacity of the plant and its production characteristics with certainty – facing only pricing risk of its goods. Unlike a manufacturing facility, where there is certainty as to the volumes capable of being produced or processed, oil and natural gas producers bear the additional risk of uncertain volume, or production capacity. Again, this additional risk faced by oil and gas producers makes the nature (and hence the tax treatment) of these expenditures different from normal construction costs.

These types of factual differences are often lost on those unfamiliar with the oil and gas business, but they were instrumental in the formulation of the proper tax treatment for costs related to those activities. Such tax treatment should not be changed without a full appreciation of the underlying nature of the business and nature of the expenditures that oil and gas development and production require.

Congressional Action on IDCs—Congressional confirmation of IDCs as operating costs

The phrase “intangible drilling and development costs” eventually showed up in the legislation when, in 1940, Congress sought to impose an excess profits tax to support the war efforts. Section 711 of the Act (Codified in the 1939 Code as Section 711)⁹, in defining “Excess Profits Net Income,” outlined the adjustments to be made to normal-tax income, including one limiting the use of deducted IDCs:

*All expenditures for intangible drilling and development costs paid or incurred in the drilling of wells or the preparation of wells for the production of oil or gas, or expenditures for development costs in the case of mines, which the taxpayer has deducted from gross income as an expense, shall not be allowed to the extent that in the light of the taxpayer’s business it was abnormal for the taxpayer to incur a liability of such character or, if the taxpayer normally incurred such liability, to the extent that the amount of such liability in the taxable year was grossly disproportionate to the amount of such liability in the four previous taxable years; . . .*¹⁰

In connection with the Revenue Bill of 1942, Congress rejected a proposal to change the treatment of oil and natural gas drilling and development costs, instead explicitly reaffirming its treatment by adopting House Concurrent Resolution 50:

Resolved by the House of Representatives (the Senate concurring). That in the public interest the Congress Hereby declares that by the reenactment, in the various revenue Acts beginning with the Revenue Act of 1918, of the provisions of section 23 of the Internal Revenue Code and of the

⁹ Pub. L. No. 801, Second Revenue Act of 1940, Sec. 711(b)(1)(H), 54 Stat. 974, 1940.

¹⁰ - Pub. L. No. 10, Excess Profits Tax Amendments of 1941, Sec. 3, 55 Stat. 8, 1941. amended 1939 Code Section 711 to clarify the nebulous “disproportionate” language of the prior act, but also gave a legislative nod to the deduction for intangible drilling and development costs: *Intangible Drilling and Development Costs. – Deductions attributable to intangible drilling and development costs paid or incurred in or for the drilling of wells or the preparation of wells for the production of oil or gas, and for development costs in the case of mines, if abnormal for the taxpayer, shall not be allowed, and if normal for the taxpayer, but in excess of 125 per centum of the average amount of such deductions in the four previous taxable years, shall be disallowed in an amount equal to such excess . . .*

corresponding sections of prior revenue Acts allowing a deduction for ordinary and necessary business expenses, and by the enactment of the provisions of section 711 (b) (1) of the Internal Revenue Code relating to the deduction for intangible drilling and development costs in the case of oil and gas wells, the Congress has recognized and approved the provisions of section 29.23 (m)—16 of Treasury Regulations 111 and the corresponding provisions of prior Treasury Regulations granting the option to deduct as expenses such intangible drilling and development costs¹¹.

The House Report to the Resolution expressed the intent of Congress was “. . . to remove any doubt as to the validity of Treasury regulations giving to the taxpayer the option to either capitalize or charge to expense intangible drilling and development costs in the case of oil and gas wells.” Congress indicated that the “uncertainty occasioned by the raising doubts as to the validity of these regulations is materially interfering with the exploration for and the production of oil,” deemed “essential for the maintenance of our military and civilian requirements.” Congress further noted that the regulations had been in effect continuously for 28 years and Congress had adopted the same basic statutory provisions since that time from which these regulations are derived¹².

Regulations 118, approved September 23, 1953, retained the option to expense intangible drilling costs incurred by the operator¹³. With the re-codification of the tax laws in 1954, the IDC deduction was finally given clear imprimatur of the law in the Internal Revenue Code of 1954 with the adoption of Section 263 (c):

Intangible Drilling and Development Costs in the Case of Oil and Gas Wells. — Notwithstanding subsection (a), regulations shall be prescribed by the Secretary or his delegate under this subtitle corresponding to the regulations which granted the option to deduct as expenses intangible drilling and development costs in the case of oil and gas wells and which were recognized and approved by the Congress in House Concurrent Resolution 50, Seventy-ninth Congress¹⁴.

Congress has subsequently imposed some limitations on the ability to expense IDCs over time, but the underlying principle and the treatment of such costs as more in the nature of operating costs than permanent improvements to property benefitting the investor has been largely unchanged.¹⁵

Economic Impacts of the IDC Deduction—Why changes affect drilling levels

Reasonable cost recovery is not unique to the oil and natural gas industry. It is available and essential to all business operations. American companies spend millions - sometimes billions - of dollars building infrastructure and investing in their industries here at home. These costs must be recovered in order to reinvest in the next breakthrough technology or the additional employee. Capital intensive businesses, therefore, operate under a

¹¹ H. Con. Res. 50, 79th Cong., 1st Sess., July 21, 1945.

¹² H.R. Rep. No. 761, 79 Cong., 1st Sess., June 19, 1945

¹³ Section 39.23 (m)—16

¹⁴ Internal Revenue Code of 1954, 68A Stat. 77 (1954).

¹⁵ As a result of several tax changes in the 1980's, integrated companies can currently expense 70% of domestically incurred IDCs, with the remaining 30% recovered over 60 months. Independent oil and gas producers (i.e., those with little or no refining or retail marketing operations) continue to be able to fully expense their domestic IDCs as incurred, although all domestic IDCs in excess of a 5 year amortization period are treated as an alternative minimum tax preference item under Section 59(e). Foreign IDCs are amortized over 10 years.

regime where cash flow is very important and a simple tax approach does not illustrate the very complicated connection between business decisions and the tax world.

That connection, for the oil and natural gas industry at least, focuses on two equations:

First Equation:

$$\text{Revenue} - \text{Drilling Costs} - \text{All Other Deductions} = \text{Taxable Income} \times 35\% = \text{Tax}$$

Second Equation:

$$\text{Cash Revenue} - \text{Cash Outlays} - \text{Taxes} = \text{Cash Available for Additional Drilling}$$

Many are able to grasp the first equation; that is, increasing oil and natural gas companies’ taxable income (by disallowing deductions) will produce more tax. However, many also ignore the second equation; that is: greater taxes reduce the amount of cash available for continued drilling or – said differently – less exploration and production of available U.S. energy resources. Both equations play into a US business investment decision and ignoring the second equation is to ignore the direct impact that could be felt by Americans across the country, whether in oil and natural gas regions or not.

The economic policy basis behind the IDC deduction acknowledges the second equation and the benefit of putting energy capital to work in drilling programs and the production of oil and natural gas to meet the demands of the U.S. economy. The very moment a well is completed and starts producing, it becomes a wasting asset that will eventually be used up. Accordingly, to maintain supply, additional drilling for new production must be immediately started to fill in as the first well depletes. Increasing taxes on oil and gas companies in any significant way has a dramatic, negative effect on the U.S. oil and natural gas investment, thereby reducing production and supplies.

It is correct to note that the disallowance of IDC as a current deduction results in increased government taxes in the first year. But it should also be noted that businesses that are looking to grow and manage shareholder money must look further out on the timeline. In the first year (and every year thereafter), energy companies will have less cash available for additional drilling, which will directly lead to less production. This lower production results in lower government tax and royalty revenue, as well as other potential impacts on consumers. This is a dynamic impact that compounds year after year into bad news for consumers and energy companies. Here is a simplified example:

	Current Tax/Cash Flow Impact:	Tax/Cash Flow Impact (10 yr Amortization)
Tax Calculations		
Revenue	\$1,000	\$1,000
Drilling costs	(\$400)	(\$40)
All Other Deductions	(\$100)	(\$100)
Taxable Income	\$500	\$860
Tax Rate	35%	35%
Tax	\$175	\$301

Cash flow		
Revenue	\$1,000	\$1,000
Cash outlays	(\$500)	(\$500)
Taxes	(\$175)	(\$301)
Cash Available for Drilling	<u>\$325</u>	<u>\$199</u>

Based on the above example, government will realize an increase in tax revenue in the year of enactment of \$126 (\$301 - \$175=\$126). But equally true is that drilling will go down by almost 40 percent (\$325 for drilling reduced to \$199), the implications of which include: 1) a material number of wells will not be drilled, 2) a material number of employees and contractors would be impacted, 3) wells drilled in prior years will continue to deplete without enough new wells to replace them, 4) there will be less supply of domestic oil and natural gas and thus imports will increase, and 5) government revenue will decrease in future years due to lower production.

Discounted Cash Flow Analysis—Why timing items affect drilling levels

It is also correct to note that the difference between expensing drilling costs and capitalizing the same costs is a *timing* difference. But once again, that answer is too simple and ignores the time value of money. The dollars at stake are so large that the difference in the years of deduction is enormous. The timing difference argument (i.e., there is no tax increase to energy companies over time) is a simplistic view that would not be used by any competent finance or treasury department. Companies in the oil and natural gas industry evaluate whether to invest in new projects and drill new wells based on the returns they can expect from such investments. Rates of return are directly influenced by the timing of cash outflows and inflows related to the project. Significantly delaying the timing of the tax deductibility of drilling costs significantly reduces the discounted cash flow and rate of return values such projects will generate, and thus many projects will no longer meet investment rate criteria. Thus, dismissing the significance of the proposed change by describing it as merely a timing difference, once again, ignores the impact of drilling and tax costs on the sustainability, much less growth, of U.S. energy supplies. Increasing the costs of producing energy at home—which amounts to increasing the costs of hiring American workers—is not sound economic or energy policy—it will simply result in less oil and natural gas production and supplies and fewer American jobs

IDCs Are Not Unique in the Tax Code—Comparisons to costs in other industries

The United States has historically allowed immediate deductions for costs associated with the development of technology and resources. These deductions have played a crucial role in advances in technology and have spurred transformations in the US economy in general and America’s energy sector in particular. The research and experimental cost deduction (Sec 174) and the intangible drilling and development cost deductions (Sec 263(c)) have identical policy goals: to promote innovation, foster development of new products and resources, and promote economic growth. The legislative history of the codification of IDC in the 1954 Internal Revenue Code supports the potential overlap of these two sections. Section 174 also came into the code in 1954, but excluded from its coverage (by Section 174(d)) oil and natural gas exploration expenditures, specifically noting in

the legislative history that coverage of such costs under Section 174 was not necessary because they had been covered separately under Sec. 263(c).¹⁶

The largest costs deducted under Sec. 174 by companies such as high-tech or pharmaceuticals typically consist of items such as the salary and benefit costs of researchers and their co-workers. Examples include the salary of a scientist developing new or improved drugs, or the costs associated with the development of computer software. When compared to the costs deducted under Sec. 263(c) for the oil and natural gas industry, they are virtually the same. IDCs typically consist of the salaries for drillers, as well as fuel and hauling costs. Examples include the wages of workers involved in finding and developing new oil or natural gas prospects, as well as workers involved in developing improved drilling techniques to get at hard to reach gas or to drill wells in new, unproven locations.

When one compares these extremely similar deductions, it is interesting to note that the oil and natural gas industry, through the same type of cost recovery, is actually disadvantaged compared with other industries. Under Sec. 174, high-tech and pharmaceutical costs are typically fully deductible in the year they are incurred. Furthermore, a research tax credit is available in addition to the one year deduction. However, IDC costs under Sec. 263(c) can only be fully deducted in the year they are incurred by independent oil and natural gas companies; integrated oil companies are limited to deducting 70 percent of the total costs in the year incurred, with the remainder amortized over five years, and neither generally qualifies for the additional research credit. While the economic policy rationale is the exact same for both of these provisions, in practical application, the oil and natural gas industry is at a disadvantage from an overall tax standpoint.

The bottom line is that both the R&E deduction and the IDC deduction serve identical economic policy goals: innovation, development, and growth. Eliminating the IDC deduction would discourage innovation in the energy sector, jeopardizing additional valuable advances in oil and natural gas exploration, high paying jobs, and America's energy security.

Potential Impact of IDC Repeal on the Industry & the Economy

Repealing the IDC deduction would require currently deductible costs to be recovered over an extended time period. As discussed, this significantly skews the after-tax cost of drilling labor relative to other labor activities and US drilling relative to investment in other countries. According to a Wood Mackenzie¹⁷ study, repealing IDC would discourage domestic investment and could generate following results:

- Potential loss of domestic production that could approach 600,000 boe/d
- Curtailing an expected \$130 billion of capital over the next ten years
- A more focused impact on natural gas with as around 5% of natural gas production is expected to be lost in the first year of the tax change

¹⁶ S. Rep. No. 1623 (1954), p 216.

¹⁷ "Evaluation of Proposed Tax Changes on the US Oil & Gas Industry." Wood Mackenzie. August 2010.
http://www.api.org/~media/Files/Policy/Taxes/Evaluation_Proposed_Tax_Changes_on_US_Oil_and_Gas_852010.pdf

Additionally, the repeal of IDC and other proposed tax changes for only the US oil and gas industry place thousands of jobs at risk:

- 58,800 direct, indirect and induced US jobs are at risk in the year implemented
- 165,000 total direct, indirect and induced US jobs at risk by 2020
- The Rocky Mountains, on-shore Gulf Coast, and the middle of the US have the highest potential jobs at risk

Any proposals to eliminate the IDC deduction would not only jeopardize the advances that are responsible for some of the US's biggest and latest oil and natural gas plays, such as shale oil and natural gas, but also endanger many of the 9.2 million American jobs supported by the industry.

Conclusion

Treating the labor costs and other operating expenses associated with drilling a well as deductible expenses is consistent with standard tax policy. Deviating from this standard treatment puts at risk the investment and innovation required for keeping the goal of energy independence within reach.

The US corporate tax system should be one that promotes domestic investment and international competitiveness without picking winners and losers.

Current tax treatment for the costs of drilling wells in the U.S. keeps the cost of domestic production competitive with foreign alternatives – a key component in spurring the domestic investment needed to reach America's goal of energy independence. Eliminating or further restricting the ability to expense IDCs (mostly labor costs), thereby increasing the cost of energy development in the U.S., is not only incorrect tax policy, but also bad economic, jobs, and energy policy.