

Eliminate The Net Income Limitation On Percentage Depletion

The net income limitation severely restricts the ability of independent producers to use percentage depletion, particularly with respect to marginal wells. Percentage depletion is already subject to many limitations. First, the percentage depletion allowance may only be taken by independent producers and royalty owners and not by integrated oil companies. Second, depletion may only be claimed up to specific daily production levels of 1,000 barrels of oil or 6,000 mcf of natural gas. Third, the deduction is limited to 65% of net taxable income. These limitations apply both for regular and alternative minimum tax purposes.

The net income limitation requires percentage depletion to be calculated on a property-by-property basis. It prohibits percentage depletion to the extent it exceeds the net income from a particular property. The typical independent producer can have numerous oil and gas properties, many of which could be marginal properties with high operating costs and low production yields. During periods of low prices, the producer may not have net income from a particular property, especially from marginal properties. When domestic production is most susceptible to being plugged, the net income limitation discourages producers from investing income to maintain marginal wells.

Proposal

Eliminate the net income limitation on percentage depletion.

Reasons for change

Marginal oil wells – those producing on average 15 barrels per day or less or producing heavy oil – account for approximately 20 percent of domestic oil production, an amount roughly equivalent to imports from Saudi Arabia. The U.S. is the only country with significant production from marginal wells. Once wells are plugged, access to the remaining resource is often lost forever. If the country has learned anything from high oil and natural gas prices, it is that America needs to maintain and enhance its domestic oil and natural gas production. This tax reform allows more capital to be retained by producers where it can do the most good – producing more domestic oil and natural gas. Moreover, during times of low prices, it is a significant factor in keeping marginal wells in operation.

Preserving marginal wells is central to our energy security. Neither government nor the industry can set the global market price of crude oil. Therefore, the nation's internal cost structure must be relied upon for preserving marginal well contributions.

**National Petroleum Council
Marginal Wells Study 1994**

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Current Status

Beginning with the Taxpayer Relief Act of 1997 the net income limitation on percentage depletion for marginal properties has been suspended in two year increments; this suspension is currently in place through 2005. Establishing a policy that is clear and reliable should be the next step. Congress should eliminate the net income limitation on percentage depletion for marginal wells.

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