

Intangible Drilling and Development Costs

Since 1913, the intangible drilling and development costs (IDCs) deduction has been allowed as a mechanism to attract capital for the high risk business of exploring for, and developing, American natural gas and oil. While it has been limited, the IDC deduction remains an important incentive for American natural gas and oil exploration and development.

Background

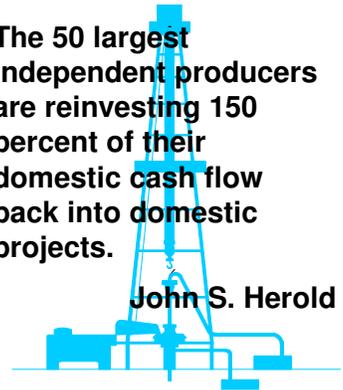
In general, costs that benefit future periods must be capitalized and recovered over those periods for income tax purposes, rather than being expensed in the period the costs are incurred. Special rules are provided, however, for the treatment of IDCs. Under these special rules, an operator or working interest owner (i.e., a person that 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) that pays or incurs IDCs in the development of an natural gas or oil property located in the United States, may elect either to expense or capitalize those costs.

Broadly, IDCs are the costs to develop a well for the elements that are not a part of the final operating well. IDCs include all expenditures made by an operator 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 natural gas and oil. In addition, IDCs include the cost to operators of any drilling or development work¹ done by contractors under any form of contract (including a turnkey contract). Such work includes labor, fuel, repairs, hauling, and supplies which are used in the drilling, shooting, and cleaning of wells; in such clearing of ground, draining, road making, surveying, and geological works (as are necessary in preparation for the drilling of wells); and in the construction of such derricks, tanks, pipelines, and other physical structures as are necessary for the drilling of wells and the preparation of wells for the production of oil and gas. Generally, IDCs do not include expenses for items which have a salvage value (such as pipes and casings), or items which are part of the acquisition price of an interest in the property.

If an election to expense IDCs is made, the taxpayer deducts the amount of the IDCs as an expense in the taxable year the cost is paid or incurred. Generally, if IDCs are not expensed, but are capitalized, they may be recovered through depletion or depreciation, as appropriate. Or, in the case of a nonproductive well ("dry hole"), they may be deducted, at the election of the operator. In the case of an integrated oil company that has elected to expense IDCs, 30 percent of the IDCs on productive wells must be capitalized and amortized over a 60-month period. Notwithstanding the fact that a taxpayer has made the election to deduct IDCs, the Tax Code provides an additional election under which the taxpayer is allowed to capitalize and amortize certain IDCs over a 60-month period beginning with the month the expenditure was paid or incurred. This rule applies on an expenditure-by-expenditure basis; that is, for any particular taxable year, a taxpayer may deduct some portion of

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¹ Excluding amounts payable only out of production or gross or net proceeds from production, if the amounts are depletable income to the recipient, and amounts properly allocable to the cost of depreciable property

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its IDCs and capitalize the rest under this provision. This allows the taxpayer to reduce or eliminate the IDC adjustments or preferences under the alternative minimum tax. The election to deduct IDCs applies only to those IDCs associated with American properties. For this purpose, the United States includes certain wells drilled offshore.

AMT Treatment of IDCs

Also as discussed above, in computing its regular tax, a taxpayer who pays or incurs IDCs in the development of American natural gas or oil properties may elect to either expense or capitalize these amounts. The difference between the amount of a taxpayer's IDC deductions and the amount which would have been currently deductible had IDCs been capitalized and recovered over a 10-year period may constitute an item of tax preference for the Alternative Minimum Tax (AMT) to the extent that this amount exceeds 65 percent of the taxpayer's net income from natural gas and oil properties for the taxable year (the "excess IDC preference").

For taxpayers other than integrated oil companies, the Energy Policy Act of 1992 repealed the excess IDC preference for IDCs related to natural gas and oil wells for taxable years beginning after 1992. The repeal of the excess IDC preference, however, may not result in the reduction of the amount of the taxpayer's Alternative Minimum Taxable Income (AMTI) by more than 40 percent of the amount that the taxpayer's AMTI would have been had the excess IDC preference not been repealed.

In addition, for purposes of computing the an integrated oil company's adjusted current earnings (ACE) adjustment to the AMT, IDCs are capitalized and amortized over the 60-month period beginning with the month in which they are paid or incurred. The ACE preference does not apply to independent natural gas and oil producers since enactment of the Energy Policy Act of 1992.

Reasons for IDCs

These costs are an important and integral part of exploration and production for American natural gas and oil. They affect the ability of American producers to engage in the exploration and development of our national petroleum and natural gas reserves. Allowing the deduction of IDCs increases capital available for American exploration and production activity

The Energy Information Administration's analyses of American energy supply continue to show that natural gas and oil will be essential to meet future demand. Crude oil imports are at an all-time high. The U.S. remains vulnerable to sharp oil price increases or supply disruptions. American exploration and production must be encouraged now to offset this potential threat to national security, to meet future needs, and to enhance our economy. Independent producers drill 90 percent of American natural gas and oil wells. A recent John S. Herold analysis concluded that the 50 largest independent producers are reinvesting 150 percent of their American cash flow back into American projects. If the country wants to encourage American development, independent producers are the key component and IDCs remain an important capital formation element.

Status

The Obama Administration proposes to repeal expensing of IDCs – this critical element of the nation's tax policy that encourages American natural gas and oil exploration and production. This proposal should be rejected because the consequence would be to reduce investment in new American natural gas and oil development – investments that produce the natural gas essential to a clean energy future, the natural gas necessary to grow solar and wind energy, the oil to reduce our growing dependency on foreign sources.

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