The Heritage Foundation Backgrounder

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IRS, IDCs AND FARMOUTS: A CRITICAL ANALYSIS

OVERVIEW:

In an attempt to alleviate the problem of individuals with high incomes paying little or no taxes, the Congress inadvertently placed a major barrier along the path towards energy sufficiency. With the enactment of certain provisions of the Tax Reform Act of 1976, Intangible Drilling Costs became a tax preference item. This change in the tax policies regarding IDCs has seriously reduced the amount of investment capital available for exploration and development in the oil industry. While there have been some moves attempting to alleviate the inequities created by the 1976 Act, they do not appear to present a complete solution to the problem. At present there remains a significant barrier to the availability of risk capital to independent drillers.

INTANGIBLE DRILLING COSTS:

Intangible Drilling Costs, or IDCs as they are known, are those items associated with the drilling of an oil well which have no salvage value. They include such costs as labor and the specialized "drilling mud" used in the drilling process. They actually constitute an expense to the operator and are not so-called "artificial losses." These expenses may be contrasted with such other tax preference items as percentage depletion which do not entail an actual cash outlay. As IDCs entail an actual expenditure of cash, the application of the minimum tax to them runs contrary to all of the principles on which the concept of the minimum tax was based. It is not uncommon for IDCs to represent as much as 60% to 70% of the total cost of drilling an oil well.

THE PURPOSE OF MINIMUM TAXES:

In considering the unique position of the independent driller with regard to IDCs, one must first consider the purpose of applying a minimum tax. As early as 1969 the Congress began to take steps to insure that Americans with high incomes paid some income taxes. It was this effort which eventually led to the enactment of the 1976 Tax Reform Act. Central to the attempt to see all individuals bear some portion of the tax burden

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was the limitation on artificial losses. These "artificial losses " actually were a mixed bag of incentives, tax expenditures, and special treatments which had come into existence over the years. For the most part, these artificial losses represented attempts by the Congress to either correct some inequity which existed in the tax code or to create some sort of stimulus to a particular type of investment. Among more commonly understood "artificial losses" are such items as accelerated depreciation on equipment and the percentage depletion.

Individuals with high incomes who wished to minimize their tax burdens frequently took advantage of various types of artificial losses by forming partnerships which then invested money in businesses which enjoyed them. One result of such investments was that some individuals with extremely high incomes were able to escape paying any taxes at all. Because one of the more popular "tax shelters" was the percentage depletion from oil wells, much Congressional attention was focused on oil drilling operations when this problem was considered. The end result of the deliberations by the House Ways and Means Committee was to attempt to place limitation on artificial losses. While it was the intent of the Congress to keep incentives for legitimate investment, the Members wished to insure that all individuals would pay some taxes. Two of their actions in this regard directly impacted the independent oil driller: the phase-out of the percentage depletion and the imposition of the minimum tax on IDCs. In the case of IDCs, the result of their deliberations is clearly in conflict with their intent.

THE INDEPENDENT'S TAX BURDEN:

The independent oil driller generally pays a substantial amount in taxes without the imposition of the minimum tax on IDCs. Part of this is the result of the phase-out of the depletion allowance. Currently, the percentage depletion is limited to 65% of taxable income. This limitation in essence imposes a minimum tax on these individuals' incomes. While a recently passed amendment to the 1976 Act corrects some of the problems with the minimum tax on IDCs, the imposition of any tax seems counterproductive.

The way that the tax on IDCs operates is that the amount of Intangible Drilling Costs in excess of what might have been deducted from gross income if they were amortized over 10 years and capitalized is added to the amount of IDCs in excess of the individual's net oil and gas income. This sum is usually equal to the total amount of IDCs for a given well. These IDCs are then added to the other tax preference items. The individual may deduct either $10,000 or half of his income tax liability from the total amount of preference items he has and then must pay a 15% tax on the balance. The way that this works out is that the independent driller usually winds up paying the 15% tax on all of his IDCs. Under previous tax law, the individual could deduct 100% of his income from his preference items. Lowering the percentage of the allowable deduction by half has removed much of the incentive for risk capital to make itself available for drilling operations.

Prior to enactment of the 1976 Tax Reform Act when 100% of the taxes paid by an individual were deducted from the minimum tax, there existed a powerful incentive for outside investment. At a time when our nation is facing serious shortages of both oil and natural gas, it seems unreasonable to eliminate incentives for capital formation in the industry which is directly involved in the search for additional supplies of these commodities.

With the phase-out of the percentage depletion through 1984, one of the major cash-generating tools available to the independent driller will be eliminated. Price controls on the sale of oil and natural gas have further limited the independent's ability to generate a cash flow. Now we have the creation of a tax preference with regard to IDCs. The net result of these various measures is to hamper all of the driller's traditional sources of operating capital. At a minimum, the tax on IDCs represents a surcharge on successful wells and creates a strong disincentive for the operation of marginal units. It should also be noted that 14% of the oil and gas produced in the United States comes from marginal wells.

FARMOUTS:

A common practice in the oil industry is for the owner of the oil right on a given property to "farm out" the drilling of an oil well on that property. This practice of "farmouts" is particularly important to Louisiana where it is fairly common for an individual to own the mineral rights to an extensive block of acreage. The manner in which this farming out of drilling operations is generally carried out is that an independent driller agrees to drill what is called an "obligation well." This well is drilled on the owner's property with the understanding that the independent operator assumes the risk of drilling a dry well. If the well is successful, the independent driller is assigned title to a previously agreed upon portion of the acreage surrounding the drilling site. This portion of acreage is intended to represent the owner's portion of the costs of the drilling operation. As a rule the independent driller holds 100% of the well until he recovers his costs; and thereafter, the owner of the property and the driller each will have equal shares in the operation. The actual purpose of the assignment of acreage is to act as an incentive to attract independents to drill on the property as it allows them to drill additional wells if the first is successful.

RECENT IRS ACTION:

Under a recent IRS ruling, the land which the driller receives from the owner of the property is treated as current income. Put plainly, this means that the receipt of the property is the same as receipt of cash in an amount equal to the fair market value of the land in the eyes of the Internal Revenue Service. The IRS ruling also states that the transfer of the property from the owner to the driller would be considered as if

it were preceeded by a cash sale of the property. This means that the owner of the property also may face a tax liability on the basis of whatever profit a cash sale of the property would have realized. In both cases, however, neither individual has actually received any cash. This means that they may be faced with a tremendous tax burden without the resources to pay it. At a minimum, both individuals will have to divert capital from other more productive uses to pay their tax liability.

What the Internal Revenue Service has actually done is to create a legal fiction. It has essentially said that a transaction took place in which both sides would be treated as if they were sellers. In the case of the owner of the mineral rights, it is as if that individual were to have sold property for cash at which time he is considered to have had taxable income. In the case of the independent driller, it is as if the individual had sold a service. While it is true that lawyers are not to create such fictions, this particular instance stretches credibility.

Not only is there a strong disincentive to exploration and development inherent in the IRS ruling, but there is a strong disincentive to capital formation as well. It is obvious that as of the ruling, any operator who enters into a "farmout" agreement will have to set aside a significant portion of his resources to provide for the payment of the taxes generated by the transfer of the property. At the same time, owners of the property, who might have also been investors in drilling operations (in fact, they frequently are), would also suffer a severe strain on their cash flow. The net result of the ruling is to make less capital available for the purpose of finding and pumping more oil.

CONCLUSION

At a time when our nation is facing a crisis of monumental proportions with regard to oil and gas, it is outrageous to follow policies which hamper the development of additional supplies of these resources. Independent drillers are involved in a particularly risky area of endeavor and therefore have enough difficulty in obtaining investment capital as is. To place additional barriers in the path of capital formation constitutes a gross inequity. Further, to the extent that we hamper domestic development of oil and natural gas, we become more dependent on unreliable foreign sources. While Prince Fahd had indicated that the Saudies do not intend to use oil as a political weapon, the memory of the 1973 embargo is still fresh in the minds of most Americans. The only real safeguard against a repeat of the embargo lies in the development of our own oil and natural gas. This development cannot proceed, however, without the investment capital to finance it. It would, therefore, appear counterproductive to tax IDCs or the transfer of acreage in farmouts, but only time will tell if our legislators will have the foresight to see this.

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