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INTANGIBLE DRILLING COSTS: A TAX ON RISKS

INTRODUCTION

Tax hikes need not be huge to do great damage to the economy. In some instances, even very small tax increases can have effects far outweighing the marginal additional tax dollars they generate. A case in point is the minimum tax on so-called Intangible Drilling Costs, or IDCs.

Intangible Drilling Costs are outlays for non-salvagable capital expenditures associated with a mining operation. Because these items have no salvage value, mining operations (including oil and gas drilling) long have been allowed to treat them as expenses. As such, they could be taken in the year in which they occurred rather than spread out over the productive life of the property. Mining for any of the 105 minerals eligible for the depletion allowance is entitled to the deduction for IDCs. Examples of IDCs from the oil industry include the cost of building a road to the site of an exploratory well, of casings for the well shaft, and of pipelines to gather oil from the site which would be abandoned after the well is depleted.

IDCs are important to the oil industry because they are a principal means of attracting risk capital. Typically this has been done by investors forming a limited partnership with an oil driller. They could then use a portion of the IDC deduction to "shelter" other income. Given the extreme risks of investing in oil production, it is highly unlikely that adequate capital would be available without the existence of such tax incentives.

Yet the IDC's role as a tax shelter makes it a frequent target of congressional ire. Liberals in the House and Senate have attempted to place a minimum tax on Intangible Drilling Costs several times in the last few years. Until now, their efforts have failed. This could change, however, not because of a successful liberal attack on IDCs, but because some conservatives lately have joined the attack.

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THE ISSUE

Many Members of Congress assume that IDCs are an accounting device intended to create a "paper loss." This is not true. Every dollar allowed as an IDC deduction represents an actual dollar expended. Moreover, unlike other types of investments, these outlays cannot be financed. Oil exploration is what is called a "current cash" business. This means that a firm's cash flow, or cash from the equity participation of investors, pays the costs of drilling a well. Drilling mud, casing, and other items typically included as IDCs thus are paid for in cash, directly by the investors. In this respect, IDCs differ from other kinds of tax shelters which provide the "paper loss" that so concerns the Congressmen.

Take, for example, the depreciation allowed to investors in a building. In most cases, a building would be financed through a multi-year mortgage. Interest on the mortgage paid each year is deducted as an expense, because it represents an actual cash outlay. In addition to the interest deduction, however, investors are also allowed to deduct a portion of the building's construction cost each year over a period (now twenty years) arbitrarily determined to be its useful life. At the end of this period, when the structure has been fully depreciated, its "book value" would be negligible. However, despite this minimal "book value," its actual market value might well be far greater than its construction cost.

With IDCs, on the other hand, there will be virtually no resale value from the items deducted. Even if some, such as holding tanks or pipe, could be sold as scrap, the money generated through such sales would in no way approach their original acquisition cost, much less exceed it. Therefore, the loss occurring with IDCs, unlike building depreciation, is real.

Oil and gas drilling is also a much riskier investment than a building, and this should warrant different tax treatment. When a firm or an individual purchases a capital asset such as a piece of equipment or a building, there is relatively little chance that the investment will lose all its value. There is always the prospect of recapturing at least some portion of the original investment through resale. With IDCs, however, the risk is quite high. Only around ten percent of all exploratory wells are successful; a dry hole has no buyers. In fact, the only sort of capital investment that carries anywhere near the degree of risk associated with oil and gas exploration is research and development. Yet, research and development is always taken in full as a tax deduction in the year it occurs, is considered an expense rather than being stretched out over several years, as capital expenditures are, and is not subject to any sort of minimum tax.

Much of the rhetoric concerning the minimum tax on IDCs has centered on the notion of "loopholes," carrying with it the implication that oil drillers are somehow escaping payment of

their fair share of the tax burden. Yet that burden is widely misperceived. To be sure, oil companies enjoyed a variety of special tax advantages in years past. Many of these, however, have been eliminated or severely curtailed. Further, the oil industry also has been burdened with many discriminatory federal regulations over the last several decades that sharply limited the actual income oil firms could realize from their production.

For instance, the depletion allowance, so frequently cited by industry critics as typifying preferential tax treatment, was eliminated for all but a handful of small producers in 1975. The simple fact is: the oil industry pays more taxes than many industries. Oil company 1981 federal income tax payments amounted to approximately 38 percent of pre-tax income. In addition, the oil industry pays the windfall profits tax which generated some $26 billion for the federal treasury in 1981. All together, oil industry tax payments equal 57 percent of pre-tax income, far more than the average for all other firms.

Taxes, however, have not been the only way in which federal actions have affected oil producers' potential profitability. Since 1954, the interstate sale of natural gas has been subject to federal price ceilings; in 1978, those ceilings were extended to intrastate gas sales. Although the controls are to expire in 1985, there is talk in Congress of extending their life indefinitely. Similarly, crude oil and refined products were subject to federal price controls from 1971 until 1981. A Reagan veto was required to prevent enactment of standby legislation that could have led to controls being imposed once again. In short, there is little substance to the notion that the oil industry does not pay taxes.

The most important consideration related to the minimum tax on IDCs, however, is the potential harm to America's efforts to develop domestic energy resources. Exploratory drilling is extremely sensitive to changes in the economy affecting cash flow. This is demonstrated by the sharp decline in drilling activity that has accompanied the slide in world oil prices. According to the Independent Petroleum Producers Association, some 1,500 drilling rigs are idle at present, with the resulting loss of approximately 40,000 jobs. Investment from outside the industry--a principal source of capital--has been reduced by half.

The Department of Energy contends that imposing the minimum tax will have a negligible effect on drilling and exploration. Industry experts strongly disagree. They note that the tax will fall most heavily on the new, aggressive firms which were founded after 1974. By and large, these companies lack extensive petroleum reserves and therefore are more likely to risk drilling at marginal sites.

These new firms, predictably, lack the financial resources of older, more established companies. They generally do not hold leases on large tracts of producing acreage to provide a buffer

during price fluctuations and an internal source of capital to finance new exploration during times of tight money. As a result, a minimum tax on IDCs almost surely will doom a number of these entrepreneurial firms to fail. Yet without venturesome companies willing to drill in marginal areas, U.S. oil reserves are certain to decline.

CONCLUSION

In short, the tax on IDCs typifies the kind of punitive levy about which supply-side theorists warn. It has a direct and immediate negative effect on employment and Gross National Product far exceeding any nominal tax dollars collected. It discourages real investment and reduces capital outlays. To make matters worse, the sector of the economy affected, energy development, is among the most critical in terms of national priorities. Moreover, the damage inflicted by the tax is not limited to the domestic economy. It has enormous implications for U.S. balance of payments, the extent to which America remains dependent on foreign oil, and ultimately on U.S. defense spending. An IDC tax is an issue far transcending whether or not a few independent oil producers will survive the current recession. Rather, it involves a wide range of economic, political, and strategic issues.

It is puzzling, therefore, that Congress seems to view the minimum tax on IDCs primarily as a means of raising revenues. This is short-sighted. The U.S. has begun making significant headway in the past three years toward reversing the decades-long trend of declining oil reserves. In 1981, for the first time in recent memory, new additions to proved oil reserves actually exceeded the amount consumed. It was widely expected that the 1981 reserve additions signaled the dawn of a new era of oil development that would lead to true national energy security. Some observers even believed that the U.S. might once again be in the enviable position of relying almost fully on domestic oil resources to furnish its needs by the middle 1980s. The minimum tax on IDCs might well shatter this dream. The Independent Petroleum Producers Association estimates that the tax could result in a 30 to 40 percent reduction in expenditures for drilling and exploration and an accompanying loss of thousands of jobs. The ultimate impact of the tax, due to the likely decline in new field discoveries, is sure to be higher prices and an increased dependence on foreign oil.

A minimum tax on IDCs thus places an additional tax on an industry already overburdened with taxes and serves to retard capital investment just when it is needed most. The revenues it may generate in the short-run will be more than offset by the loss of tax dollars which would otherwise flow from the firms that are forced out of business by the loss of access to risk capital. If Congress would consider the minimum tax on IDCs in a context broader than revenue raising, these facts would become self-evident.

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