Tax Advantages of Oil and Gas Drilling

Congressional Incentives Encourage Domestic Petroleum Development
Oil and Natural gas from domestic reserves helps to make our country more energy self-sufficient by reducing our dependence on foreign imports. In light of this, Congress has provided tax incentives to stimulate domestic natural gas and oil production financed by private sources. Drilling projects offer many tax advantages and these benefits greatly enhance the economics. These incentives are not "Loop Holes" -- they were placed in the Tax Code by Congress to make participation in oil and gas ventures one of the best tax advantaged investments.

Intangible Drilling Cost Tax Deduction
The intangible expenditures of drilling (labor, chemicals, mud, grease, etc.) are usually about (65 to 80%) of the cost of a well. These expenditures are considered "Intangible Drilling Cost (IDC)", which is 100% deductible during the first year. For example, a $100,000 investment would yield up to $75,000 in tax deductions during the first year of the venture. These deductions are available in the year the money was invested, even if the well does not start drilling until March 31 of the year following the contribution of capital. (See Section 263 of the Tax Code.)

Tangible Drilling Cost Tax Deduction
The total amount of the investment allocated to the equipment “Tangible Drilling Costs (TDC)” is 100% tax deductible. In the example above, the remaining tangible costs ($25,000) may be deducted as depreciation over a seven-year period. (See Section 263 of the Tax Code.)

Active vs. Passive Income
The Tax Reform Act of 1986 introduced into the Tax Code the concepts of "Passive" income and "Active" income. The Act prohibits the offsetting of losses from Passive activities against income from Active businesses. The Tax Code specifically states that a Working Interest in an oil and gas well is not a "Passive" Activity, therefore, deductions can be offset against income from active stock trades, business income, salaries, etc. (See Section 469(c)(3) of the Tax Code).

Small Producers Tax Exemption
The 1990 Tax Act provided some special tax advantages for small companies and individuals. This tax incentive, known as the "Percentage Depletion Allowance", is specifically intended to encourage participation in oil and gas drilling. This tax benefit is not available to large oil companies, retail petroleum marketers, or refiners that process more than 50,000 barrels per day. It is also not available for entities owning more than 1,000 barrels of oil (or 6,000,000 cubic feet of gas) average daily production. The "Small Producers Exemption" allows 15% of the Gross Income (not Net Income) from an oil and gas producing property to be tax-free.

Lease Costs
Lease costs (purchase of leases, minerals, etc.), sales expenses, legal expenses,

administrative accounting, and Lease Operating Costs (LOC) are also 100% tax deductible through cost depletion.

Alternative Minimum Tax

Prior to the 1992 Tax Act, working interest participants in oil and gas ventures were subject to the normal Alternative Minimum Tax to the extent that this tax exceeded their regular tax. This Tax Act specifically exempted Intangible Drilling Cost as a Tax Preference Item. "Alternative Minimum Taxable Income" generally consists of adjusted gross income, minus allowable Alternative Minimum Tax itemized deduction, plus the sum of tax preference items and adjustments. "Tax preference items" are preferences existing in the Code to greatly reduce or eliminate regular income taxation. Included within this group are deductions for excess Intangible Drilling and Development Costs and the deduction for depletion allowable for a taxable year over the adjusted basis in the Drilling Acreage and the wells thereon.

Tax Bill Gives Incentive to Marginal Wells

The US Senate and House of Representative have passed a tax incentive bill to help small oil and gas producers. This bill provides a tax credit of up to $9 per well per day for marginal wells. A typical marginal well pumps 15 barrels of crude or 90 thousand cubic feet of gas per day. There are 650,000 “marginal” or “stripper” oil and gas wells in the USA. Marginal wells provide as much as 25 percent of the nations’ crude supply (on par with Saudi Arabia) and about 10 percent of gas stocks. In 2002 alone, 17000 oil and gas wells were permanently plugged with cement (13,600 oil wells and 3,900 gas wells). This tax bill will act as a safety net to save many of these wells, thereby reducing our reliance on the Middle East. The tax credit phases-in if the average crude price for a year is less than $18 a barrel or $2 per thousand cubic feet of gas. The maximum tax credit is $3 a barrel for the first three barrels of crude produced if prices plunge below $15 a barrel, and 50 cents per thousand cubic feet if gas prices average less than $1.67 per thousand cubic feet. Crude oil is now above $54 a barrel on the New York Mercantile Exchange and gas futures are near $7 per thousand cubic feet.

From Houston Chronicle, October 12, 2004