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Summary Of Oil & Gas Tax Provisions In Proposed 2011 Budget

The repeal of current oil and gas tax provisions will have an estimated $3.9 billion negative impact on the Kansas economy within four years of enactment. The tax provisions are important to small, independent oil and gas producers and royalty owners – NOT "Big Oil." Independents produce 92% of the oil and 63% of the natural gas in Kansas.

Most independents are small, privately-held companies, and they invest large sums of personal money in personal risk. In order to find more oil and natural gas, independents use their money and, to a lesser extent, raise capital from investors. Percentage depletion, which has been in the tax code since 1926, helps offset some of the high risks of exploration, and helps the "mom-and-pop" producers keep small (one to two barrels per day) wells active. There are already limits on percentage depletion which is 15% of gross oil and gas income as follows: (1) limited to first 1,000 barrels per day of production; (2) limited to the net income of a property for non-marginal properties (15 barrels per day or more); and (3) after the above limitation, the amount deducted for depletion cannot exceed 65% of the taxpayers income before the depletion deduction.

While percentage depletion applies to production, intangible drilling costs (IDCs) is the cost of drilling a well. This cost is paid to a drilling company that pays wages and buys goods and services. Once the well is drilled it has no value, because all you have is a hole in the ground. Currently, IDCs can be expensed in the year they are paid or incurred by independents. This allows companies to recover their costs quickly so they can drill more wells faster. This encourages more production of oil and gas in the U.S. Expensing of IDCs has been in the tax code since 1913.

The other tax provisions on the chopping block are:

(1) repealing the passive loss exception for working interests in oil and gas properties (Investors in drilling programs are called working interest owners and they must share in the costs of the risky venture. The tax code, in effect, allows working interest owners who have a loss to be classified as an active loss that could be used to offset any type of active income instead of being treated as a passive loss.)

(2) geological and geophysical (G&G) amortization (G&G costs are incurred in the beginning of the exploration process, and are very expensive with no guarantee of recouping the costs if the venture fails. Like IDCs, the faster the independent can recapture his G&G costs the more wells he can drill and find more oil and gas. Currently, G&G costs must be amortized over two years for independents and seven years for major oil companies, but the change would increase amortization to seven years for everyone. Again, it is the independent that gets hurt.)

(3) marginal well and enhanced oil recover (EOR) tax credits.

(4) Manufacturing tax deduction.

(5) excise tax on Gulf of Mexico production.

Every change will negatively impact small independents, not Big Oil, and decrease drilling and production of oil and natural gas in Kansas and in the nation. If passed, the drilling rig count will decline to its lowest level in history within 12 months (488 rigs running nationwide in March 1999 when oil was $6 per barrel). Oil and gas production will drop and the state will lose approximately $210 million in state taxes over four years. The nation will have to import more oil; another $36 billion jolt to the economy. The President's "energy independence" goal will fail if these tax provisions become law.