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THE OUTLOOK FOR TAX INCENTIVES: THE NATURAL AND EXTRACTIVE INDUSTRIES

by

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NATURAL RESOURCES AND THE EXTRACTIVE INDUSTRIES

THE OUTLOOK FOR TAX INCENTIVES

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I Evolution of tax incentives relating to the development of material resources.

A Economic concepts advanced for the justification of these tax incentives.

Given the present energy crisis the case for tax incentives for the natural resources industry becomes stronger. Exploration in this area requires large investments of capital and assumption of a high degree of risk. Tax incentives are an attempt to make exploratory drilling and risk-taking more attractive. The intent is to encourage wildcat drilling by increasing the economic return on investment through favorable tax treatment. By thus fostering mineral production we reduce our dependence on foreign nations and under classical economic theory by increasing supply we place a downward pressure on price.

B Historical Development of Applicable Federal Income Tax Law.

Depletion has been part of the tax law since the Tariff Act of October 3, 1913. That legislation provided a deduction of a ratable portion of the cost (or value as of March 1, 1913) of the mineral property as the mineral was produced or sold, not to exceed five percent of the gross income realized from the extraction and sale of the mineral. Since in many cases the amount of the deduction was less than the cost of the property the law was amended by the Revenue Act of 1916 to allow a deduction of a ratable portion of basis without limitation.

Percentage depletion was introduced in the Revenue Act of 1926 where a 27-1/2% figure was adopted. This was reduced to 22% by the Tax Reform Act of 1969. Percentage depletion was further affected by the Minimum Tax provisions of the 1969 Reform Act under which the excess of percentage depletion over the adjusted basis of the property at the end of the year was treated as a Tax Preference and subject to a 10% tax.

I am indebted to Leonard Lauricella BS, JD for his contribution toward the development of this paper.

Prior to the Revenue Act of 1951 exploration expenditures were not specifically covered by any Federal Income Tax provision. The 1951 Revenue Act permitted the taxpayer to elect the deduction of exploration costs but not in excess of $75,000 in any one year and not exceeding four years. This was later raised to $100,000 per year and $400,000 per taxpayer. The law was further amended to remove the four year limit so that the $400,000 could be spread over the taxpayer's lifetime. In 1966 Public Law 89-570 again changed the treatment of exploration costs. Taxpayer was allowed to elect under §615 to expense his exploration costs under the same limits as under prior law. The other option was to expense exploration costs under §617 in an unlimited dollar amount but subject to recapture upon disposition of the property. The Tax Reform Act of 1969 terminated §615 with respect to expenditures after 1969.

Intangible drilling and development costs were first allowed as a deduction by Treasury Regulations in 1917. With the adoption of the 1954 Code and §263(c) the question of deductibility was settled. The availability of immediate write-off of capital expenditures has been a key feature in tax shelter planning and is under heavy attack from the Administration's Tax Report Proposal.

C Advent of Tax Shelter Programs for the Investment Public.

Tax shelters began to make their entrance into the financial planning scene in the late 1950's. At that time the maximum marginal rate was 91% and the thought of leveraging an investment with the U S Treasury picking up over 90% of the bill was very attractive. It was from this fertile ground that the idea behind Forest-Oil and the rest of the early Participation Programs was nurtured.

Today Tax Shelters are very lucrative for high income bracket taxpayers. A public outcry against individuals with large income who pay no tax has caused Representative Mills and his Committee to take a closer look at the law in this area.

D Dilemma Facing the Country.

The clear dilemma now facing the legislators is how to reconcile the present energy crisis with public concern over tax shelter abuse. Representative Mills has expressed his concern over the misuse of tax shelters but he cautiously observed that in examining the law for appropriate remedial action we must be careful not to endanger any economic activity which is essential to the nation.

II The Administration's Proposals for Tax Reform - One Approach Aimed at solving the Dilemma.

The Administration's proposals for tax reform constitute a three pronged attack in solving the dilemma.

A Exploratory Wells, Drilling Costs and Investment Credits.

The Exploratory Drilling Investment Credit will not alter the present tax law on shelters, it merely adds additional incentives for investments.

B Limitation on Artificial Accounting Losses.

The Limitation on Artificial Accounting Losses will deny the immediate deduction for intangible drilling and development costs allowed under present law until such time as oil and gas income is produced.

C Minimum Taxable Income.

The Minimum Taxable Income proposal will change the minimum tax preferences law. Presently, the excess of percentage depletion over the adjusted basis of the property at the end of the year and the untaxed one-half of net LTCG over net STCL (plus other preferences not applicable to our topic) are reduced by $30,000 plus tax paid for the year in question and a seven year carryover of any excess tax. This amount is then taxed at a flat 10% rate. The Proposal would tax preferences at a graduated rate and also prevent huge deductions from reducing taxable income to zero.

III Exploratory Wells - Drilling Costs and Investment Credits.

A Purpose.

To provide additional incentives for exploratory drilling for new domestic sources of oil and gas.

B To Whom Applicable

All taxpayers may avail themselves of this credit.

C Basic requirements.

1 Must be a Domestic Exploratory Well. There are two requirements.

(a) Domestic Well.

(i) Must be drilled within the U S interpreted as in §638(1) including

(1) Offshore wells in continental shelf.

(2) Well in Puerto Rico or any other U S possession, territory or surrounding waters.

(b) Exploratory Well.

(i) Domestic Well.

(ii) Intended to produce oil or natural gas.

(iii) Completed to the point of production or abandoned.

(iv) Drilling requirements.

(1) Not within two statute miles of horizontal distance from the nearest producing interval of a well which is or was capable of commercial oil or gas production.

(2) The bottom or any producing interval must be at least 3,000 feet below the lowest part of any known commercially producible deposit which lies closer to the earth's surface and which is penetrated by any productive well closer than two miles away.

2 Drilling Costs Qualifying as Current Deductions.

(a) Total intangible drilling and development costs §263(c) for domestic exploratory wells.

(b) Direct geological and geophysical costs not including any allocated overhead. The maximum amount qualifying for the credit may be obtained by multiplying $50,000 times the number of domestic exploratory wells drilled to a depth of at least 1,250 feet.

(i) All members of an affiliated group are treated as a single taxpayer.

(ii) Taxpayer may allocate these costs to any well he wishes, but once attributed to one well the costs may not be switched to another well.

(iii) Current deductions for drilling costs.

(1) Intangible drilling costs and geological and geophysical costs as under existing law will be deductible in the year incurred.

(c) 7% Investment Credit.

(i) Measuring the Credit.

The investment credit is 7% of all intangible drilling and development costs plus geological and geophysical costs (limited as set forth supra in III.C 2 (b)). The credit is taken for the taxable year during which a well is completed to the point of production or abandoned as a "dry hole".

(ii) Limitation on Credit.

The drilling investment tax credit is part of the regular investment tax credit and will be subject to the limitations of §46, i e, $25,000 plus 50% of the amount by which the tax for the year exceeds $25,000. Excess may be carried back three years and forward seven.

3 Supplementary 5% Credit for Productive Exploratory Wells.

(a) When Credit Applies.

Taxpayer gets a supplementary 5% of the exploratory drilling investment (both intangible drilling and direct geological and geophysical costs) attributable to a productive well as a credit against the first tax attributable to any income from property in which the well is located.

(b) Measuring the Credit.

(i) Compute taxable income from property by deducting from gross income of the property those deductions including depletion attributable to the property.

Compute tax on regular taxable income.

Compute the tax on regular taxable income (computed without regard to NOL carrybacks or carryforwards) less taxable income from the property. This amount is the limit for any additional 5% credit in any one year. (For corporations simply take 48% of taxable income from the property).

(ii) No limitation on carryforward. The 5% supplementary credit may be used to offset tax liability up to the amount of tax attributable to the property. If some or all of this credit exceeds total tax liability for the year the excess may be carried over to succeeding years without limit as to time, and credited against any tax liability in such later years until fully exhausted.

Any part of the 5% credit that exceeds tax attributable to the property may be carried to succeeding years without time limit as an additional 5% credit against such later years' tax attributable to the property with respect to which the credit was originally earned.

D Effective Date

It is proposed that the exploratory drilling credit apply to domestic exploratory wells the drilling of which is commenced after April 17, 1973. This is subject to change pending adoption of the legislation.

IV Limitation on Artificial Accounting Losses (LAL).

A Purpose.

To curtail tax shelters which have introduced substantial distortions into the income tax system through their ability to provide tax deductions at an earilier point in time than their realization of income or their abandonment.

B To Whom Applicable.

The limitations will apply to individuals regardless of whether such losses are incurred directly or indirectly through partnerships, Subchapter S corporations, or estates or trusts but not to ordinary corporations.

C Mechanics.

1 Identification of Artificial Accounting Loss.

(a) Accelerated Deduction.

(i) One which clearly relates to some future expected profit and has little or no relation to income reported in the current year. Examples would be intangible drilling expenses or double declining balance depreciation. Except as set forth in the Regulations interest is not treated as an accelerated deduction.

(b) Artificial Loss.

(i) The amount by which the accelerated deductions for the taxable year exceed the associated net related income for the taxable year.

(ii) "Net related income" is computed without regard to accelerated deductions. Accelerated deductions will then be allowed up to the amount of net related income. The excess will be an artificial accounting loss.

2 Treatment of Artificial Loss.

(a) Deduction for Artificial Losses.

(i) Denied in the taxable year incurred, it must be deferred.

(b) Deferred Loss Account (DLA)

(i) The deferred loss is added to the DLA. A deduction is allowed against the first net related income (in excess of that year's accelerated deductions) or is taken into account upon sale or other disposition of the property to which the deferred loss is attributable.

(ii) The DLA will have no effect on the basis of the property. Thus if accelerated depreciation is taken, basis will be reduced by the full accelerated amount.

(c) Operation of Deferred Loss Account

(i) A DLA will contain the accumulated artificial losses for each class of associated deductions and related income.

(ii) Each year the artificial accounting loss (the excess of accelerated deductions over net related income) is added to the corresponding DLA.

(iii) If net related income exceeds accelerated deductions in any succeeding taxable year, the amount of the excess will be deducted from the DLA and will be allowed as a tax deduction in that year

(d) Effect of sale or other disposition on DLA.

(i) If property is sold or otherwise disposed of and there remains a net balance in the corresponding DLA, the property sold or disposed of will in general be deducted from the DLA and added to the adjusted basis of the property.

(ii) In the case of a capital asset (where the basis was not reduced by an accelerated deduction), if increasing the basis would create or increase a capital loss, the allocable share of the DLA shall be allowed as a deduction in the taxable year.

(iii) The portion of the DLA attributable to a particular property is the amount in the DLA, but not exceeding the net additions to and subtractions from the DLA with respect to that property.

D Effect on other entities.

1 Partnerships

A partnership will determine its net related income or its excess artificial accounting loss attributable to partnership property and report to each partner his distributive share.

The partner may treat his distributive share of the LAL item as though he owned a comparable interest in the partnership property outright. Thus a partner may offset his personal net related income with his share of the partnership artificial loss and vice versa.

2 Subchapter S Corporations

A subchapter S corporation will determine its net related income or artificial loss and report to each shareholder his ratable share. A shareholder will receive the same treatment for his share as that accorded to a partner in a partnership.

3 Trusts and Estates

LAL will apply to trusts and estates in the same manner as it applies to individuals. Distributable Net Income under §643(a) may be affected.

E Effective date

It is proposed that LAL be made applicable to taxable years beginning after December 31, 1973 but only with respect to transactions entered into or commitments made after April 30, 1973, however this is subject to change. Wilbur Mills and Herman Schneebeli have already issued a joint statement to the effect that any amendments affecting tax shelter provisions would be effective according to the date set in Committee decisions some time next fall.

For Real Estate, Minerals, Farming, and Net Leases consult the specific topic in the legislation.

V Minimum Taxable Income

A Purpose

To assure that every individual will pay a reasonable amount of Federal income tax relative to the size of his income.

B Thrust of the Proposal.

This proposal has the potential to effectively deny to certain individuals ordinary deductions of substantial amounts, principally charitable contributions and state and local income taxes.

C Mechanics

1 For purposes of tax shelters in the extractive industries the important preferences are one-half of the excess of net LTCG over net STCL, and the excess of percentage depletion over the adjusted basis of the property at year end.

2 Compute Expanded Adjusted Gross Income
EAGI = AGI plus preferences.

3 Compute Minimum Taxable Income Base

MTI Base = EAGI -

(personal exemptions plus
($10,000.
(
(extraordinary medical
(expenses (i e, the amount
(by which taxpayer's §213
(medical expenses exceed 10%
(of EAGI).
(
(extraordinary casualty losses
(in excess of 10% of EAGI).
(
(investment interest and other
(expenses deductible under §212
(to the extent of investment
(income.

4 MIT - MTI Base $\div$ 2.

5 Tax will be calculated on the greater of MTI Base or taxable income as computed under present law.

D Effective date

It is proposed that MTI apply to all taxable years beginning after December 31, 1973, but again this is subject to change.

VI Chances of Proposals Being Enacted into Law.

Accepting the obvious premise, namely, that none of the proposals would be enacted into the Code without some, and even perhaps, substantial modification, it seems that:

A Exploratory Wells, Drilling Costs and Investment Credits.

A good chance for enactment - consider the energy crisis.

B Limitation on Artificial Accounting Losses.

A good chance for enactment - consider bad press received by tax shelters, general concensus of public opinion appears to be that they are wasteful and serve little if any economic purpose - force oil and gas tax shelters to be of the exploratory type which is desirable in light of the energy crisis.

C Minimum Taxable Income.

A poor chance for enactment, but the existing minimum tax concepts will be amended with a view toward increasing the tax burden on taxpayers currently subject to these provisions. Consider that nonprofit organizations are vigorously opposing this proposal.

VII A Look Ahead through Avenues for Tax Planning.

Taxpayers should be actively exploring ways and means for maximizing tax saving potentials and minimizing adverse tax impacts inherent in the Administration's proposals.

A One Game Plan for High Tax Bracket Individuals.

1 Investments Suitable for Individuals.

(a) Exploratory Well Drilling Programs.

Drilling costs deductions are not inordinately delayed and investment credits at the individual level would probably be welcomed.

2 Investments Suitable for Certain Corporations Controlled by Individuals.

(a) Tax shelters other than of the exploratory well drilling type provided the corporation has income that would otherwise be taxed to controlling individual shareholders.

(i) Artificial accounting loss and minimum taxable income concepts do not apply to "ordinary" corporations.

(b) Corporations which would be Suitable Vehicles.

(i) Personal Holding Company
Artificial accounting losses would offset PHC income required to be distributed to shareholders currently. Charitable contributions deduction limits for a PHC are equivalent to those available to individuals. The net effects are obvious.

(ii) Professional Corporation

Tax minimization opportunities similar to those available to PHC, but consider:

(1) PC must be qualified under state law to be so treated for Federal income tax purposes, and most, if not all state PC laws limit PC to professional activities and passive investments.

Query

Is a tax shelter a passive investment under such concepts?

(2) PC charitable contribution deduction limited to 5% of net income without regard to such deduction.