PROVISIONS OF THE TAX REFORM ACT OF 1976 DIRECTLY AFFECTING THE DOMESTIC OIL AND GAS INDUSTRY

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The comprehensive Tax Reform Act of 1976 ("the Act") makes substantial changes in the taxation of oil and gas transactions. The changes most affecting oil and gas operators include "at risk" limitations on deductions for expenses, reduction in capital gains benefits allowable on certain oil and gas properties, and new minimum tax provisions. In addition, the Act's percentage-depletion provisions clarify previous laws.

DEDUCTIONS LIMITED TO AMOUNTS "AT RISK"

Deductions by taxpayers other than regular corporations engaged in the exploration for oil and gas resources as a trade or business or as an investment are limited to the total that such taxpayers have "at risk." Any loss disallowed for the year as a result of this limitation is to be carried over to the next taxable year.[1] The number of years to which the disallowed loss may be carried over appears to be unlimited, although the Act is unclear on this point.

A taxpayer is considered "at risk" in each activity (defined below) to the extent of "the amount of money and the adjusted basis of other property contributed" to the activity.[2] In addition, a taxpayer is considered "at risk" to the extent of certain borrowings. If the taxpayer is "personally liable" on the borrowings, he is considered "at risk" to the full extent of the amounts borrowed.[3] If he is not personally liable, the taxpayer is "at risk" only to the extent of the "net fair market value" of the property pledged, and such property may not be used in the activity.[4] No property pledged as security is to be considered "at risk" if it is directly or indirectly financed by indebtedness on a property contributed to the activity.[5] Also, the pledged property is not considered "at risk" if the amounts are borrowed from any person who has an interest (other than as a creditor) in the "activity" or from any person who is a "related party" (as defined below).[6] Finally, the taxpayer is not considered "at risk" if he is "protected against loss through nonrecourse financing, guarantees, stop-loss agreements, or other similar arrangements."[7]

An "activity" is defined to include (among other things) an oil or gas property, a partner's interest in a partnership, or a shareholder's interest in an electing small business corporation.[8] Presumably all oil and gas properties held by a partnership or by an electing small-business corporation are considered one activity under this definition.

These provisions of the Act apply to taxable years beginning after December 31, 1975.

REDUCTION IN CAPITAL GAINS BENEFITS ON CERTAIN OIL & GAS PROPERTIES

Effective January 1, 1976, gains from the disposition of oil and gas properties will be treated as ordinary income (recaptured) to the extent of intangible development costs ("IDC") incurred after December 31, 1975.[9] This recapture amount is to be "reduced by the amount (if any) by which the deduction for depletion . . . would have been increased" if the IDC had been capitalized rather than deducted.[10] The example of a sale at the top of the following page illustrates this provision.

In this example (if the required holding period had been met to allow long-term capital gains treatment for the sale), $480,000 would be considered ordinary income and $420,000 would be considered long-term capital gain.

Sale Price		$1,000,000
Tax basis of property		100,000
Income from sale		$ 900,000
IDC incurred after December 31, 1975		$ 500,000
Additional depletion allowable if IDC capitalized rather than deducted		20,000
		$ 480,000
* Allowable depletion if IDC capitalized	$130,000	
Allowable depletion without regard to IDC (Cost = $30,000, percentage = $110,000)	(11,000)	
	$ 20,000	

If an undivided interest in the oil and gas property had been involved, recapture of only a proportionate part of the IDC would be required.[11]

NEW MINIMUM TAX PROVISIONS

The new minimum tax rate is 15 percent (increased from the previous 10 percent).[12] Tax-preference items may be reduced by an exemption of $10,000 or the regular tax deduction for the taxable year, whichever is greater. The regular tax deduction is defined as an amount equal to one half (or in the case of a corporation, 100 percent) of the taxes imposed under the regular federal income-tax provisions, reduced by allowable credits.[13] Under previous law, a $30,000 exemption was allowed, and all taxpayers were able to deduct, in addition, 100 percent of the current taxes paid. Further, they were allowed to deduct unused regular taxes carried over from previous years. This carryover is not allowable to taxpayers (other than certain financial institutions and corporations having timber preference income) with taxable years beginning after December 31, 1975.[14]

The Act adds a new tax preference item, "accelerated IDC," defined as the excess of deductible IDC paid or incurred during the taxable year over the amount which would have been allowable if such IDC had been capitalized and amortized over the life of the property.[15] Dry holes are not considered IDC for this purpose. To reduce the IDC tax-preference item for the year, a taxpayer may choose a straight-line amortization over a 120-month period *or* a units-of-production method similar to cost depletion. IDC is not considered a tax-preference item for corporations, other than electing small business corporations or personal holding companies.[16]

The following example illustrates the increase in taxes to an individual taxpayer as a result of the new provisions.

Taxpayer's regular tax	$10,000
IDC (net of any allowable amortization)	$50,000
Other tax-preference item-- percentage depletion, etc.	$40,000

Calculation of Tax

	Old Law	New Law
Tax-preference depletion, etc.	$40,000	$40,000
IDC	-	50,000
Total tax-preference items	40,000	90,000
Exemption	(30,000)	(10,000) *
Regular tax deduction	(10,000)	- *
Taxable tax preferences	$ -0-	$80,000
Minimum tax (15% of $80,000 under new law)	$ -0-	$12,000
Regular tax	10,000	10,000
Total tax	$10,000	$22,000

* Taxpayer is allowed the higher of the $10,000 exemption or 1/2 of his regular taxes ($\frac{\$10,000}{2}$ = $5,000).

In this example, the amounts payable are more than doubled under the same set of figures. The example shows that the new tax provisions will have a substantial effect on taxpayers engaged in the oil and gas industry. Taxpayers who have not been previously affected by the minimum tax provisions may now have substantial amounts payable. In the example above, the taxpayer's tax would have increased by $4,500 even without the addition (to the minimum tax base) of intangible development cost.

The minimum-tax provisions are effective for taxable years beginning after December 31, 1975. Specific transitional rules are provided for corporations.

PERCENTAGE DEPLETION

The Tax Reduction Act of 1975 specified that percentage depletion will not be allowable to retailers of oil, natural gas, or products derived from oil or natural gas. The current Act excludes (from the definition of retail sales for this purpose), bulk sales of natural gas to commercial or industrial users. Furthermore, retail sales outside the United States are not considered disqualifying retail sales (assuming no domestic oil or natural gas production of the taxpayer or a related person is exported during the taxable year or the immediately preceding taxable year). A taxpayer will not be considered a "retailer" if the combined gross receipts from disqualifying retail sales of all retail outlets taken into account for purposes of this restriction do not exceed $5,000,000 for the taxable years.[17]

The Tax Reduction Act of 1975 further specified that transfers of "proven" oil and gas properties would result in the disallowance of percentage depletion to the transferee. The only exceptions to this rule were certain transfers to controlled corporations under Section 351 of the Internal Revenue Code and transfers at death. Additional exceptions for transfers of "proven properties are provided by the new act. They include the "change of beneficiaries of a trust by reason of a death, birth, or adoption of any vested beneficiary (if the transferee was a beneficiary of the trust or is a lineal descendent of the settlor or any other vested beneficiary of the trust)."[18]

In addition certain transfers of oil and gas properties within the same controlled group of family are excluded from the transfer provisions. These exceptions apply only so long as the tentative oil quantity (the 1,800-barrel per day limit effective in 1976) is required to be allocated between the transferor and transferee. Items which come under this favorable provision are transfers of "proven" properties between the following.

1. Corporations which are members of the same controlled group of corporations
2. Business entities under common control
3. Related persons in the same family
4. A trust and related persons in the same family to the extent that the beneficiaries of the trust are and continue to be related persons in the family that transferred the property.[19]

The new act provides that any distribution to the beneficiary of a trust are to be added back to that trust's taxable income for purposes of calculating the 65 percent limitation on deductibility of percentage depletion.[20] The Senate committee reports state that for purposes of calculating the 65-percent limit, cost depletion on properties subject to the independent producers and royalty owners exemption must be deducted from taxable income (before depletion) under certain circumstances. If cost depletion attributable to a property exceeds allowable percentage depletion before the application of any limits, then such cost depletion must be subtracted from taxable income before depletion in making the 65-percent calculation.

Partners are now to maintain their basis in oil and gas properties owned by the partnership at the partner level.[21] This provision means that gains on sales of oil and gas properties,as well as percentage depletion, will be calculated at the partner level.

All new percentage depletion provisions are to be effective January 1, 1975, since they are considered to be clarifications of the Tax Reduction Act of 1975.

CONCLUSION

While the provisions of the Act result in a substantial increase in taxes levied upon the oil industry, special tax benefits such as IDC and percentage depletion continue to be available. However, the new provisions make the calculations of tax liability more complicated. Adequate tax planning is more critical than ever if the effects of the new act are to be minimized. One new factor to be considered is the proper classification between intangible development costs (tax-preference items) and operating expenses (non-tax preference items). In the past, the proper classification of such amounts has been generally ignored because the tax result was basically the same in any event. Determination of whether a workover item is an operating expense or an amount of IDC may now become significant.

Another factor to be considered is the interplay between drilling costs and the 65-percent limit on percentage depletion. Drilling below optimum levels can severely reduce the current tax benefit to be derived from drilling. The importance of this factor is illustrated in the example on the following page.

A taxpayer has $150,000 of taxable income before any deduction for depletion or IDC, and he has $65,000 of allowable percentage depletion before any limits. To gain full current benefit of his percentage depletion deduction, the taxpayer must have a taxable income (before depletion) of at least $100,000 ($65,000 ÷ 0.65). The tax effects under three options are as follows. Option one includes no contemplated drilling. Option two includes drilling to the optimum level. Option three includes drilling as all of the taxpayer's taxable income.

	Option		
	One	Two	Three
Taxable income before depletion and IDC	$150,000	$150,000	$150,000
IDC deduction	-	(50,000)	(150,000)
Percentage depletion deduction	(65,000)	(65,000)	-
Taxable income	$ 85,000	$ 35,000	$ -0-
Minimum tax calculation:			
Tax preferences			
Depletion (assumed to be in excess of basis)	$ 65,000	$ 65,000	$ -
IDC	-	50,000	150,000
Exemption or regular tax deduction	(18,120)	(10,000)	(10,000)
Taxable	$ 46,880	$105,000	$140,000
Tax @ 15%	$ 7,032	$ 15,750	$ 21,000
Regular tax (from tax tables-married filing jointly)	$ 36,240	$ 9,920	$ -0-
Minimum tax (above)	7,032	15,750	21,000
Total tax liability	$ 43,272	$ 25,670	$ 21,000

In this example, the taxpayer was able to reduce his tax $17,602 ($43,272 minus $25,670) with the first $50,000 of expenditures, for an effective tax savings rate of 35 percent ($17,602 ÷ $50,000). However, an additional $100,000 ($50,000 to $150,000) in expenditures results in a current tax reduction of only $4,670 ($25,670 minus $21,000). This figure represents an effective tax savings rate of only 4.6 percent ($4,670 ÷ $100,000). Obviously, the cost of foregoing the current depletion deduction is substantial.

The holding period for obtaining long-term capital gains treatment will be extended to 9 months for taxable years beginning in 1977 and to 12 months in 1978.[22] Planning should take those changes into account if the benefits of long-term capital gains treatment are desired.

FOOTNOTES

1. Code Sec. 465(a)
2. Code Sec. 465(b)(1)(A)
3. Code Sec. 465(b)(2)(A)
4. Code Sec. 465(b)(2)(B)
5. Code Sec. 465(b)(2)
6. Code Sec. 465(b)(3)
7. Code Sec. 465(b)(4)
8. Code Sec. 465(c)(2)
9. Code Sec. 1254(a)(1)
10. Code Sec. 1254(a)(4)
11. Code Sec. 1254(a)(2)(B)
12. Code Sec. 56(a)
13. Code Sec. 56(a) and 56(c)
14. Act Sec. 301(g)(2)
15. Code Sec. 57(a)(11)
16. Code Sec. 57(a)(11) and 58(i)
17. Code Sec. 613A(d)(2)
18. Code Sec. 613A(c)(9)(B)(iii)
19. Code Sec. 613A(c)(9)(B)(iv), (v) and (vi)
20. Code Sec. 613A(d)(1)(D)
21. Code Sec. 613A(c)(7)(D)
22. Act Sec. 1402(a)