April 15, 2015

The Honorable Orrin Hatch
Chairman
Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, DC 20510-6200

The Honorable Ron Wyden
Ranking Member
Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, DC 20510-6200

Dear Chairman Hatch and Ranking Member Wyden:

The American shale revolution, spurred by horizontal drilling and hydraulic fracturing, has propelled the United States to become one of the biggest oil and natural gas production countries in the world; it results in creating profound economic, trade and geopolitical advantages for the country. This remarkable American energy revitalization could end if tax reform legislation limits independent producers' access to capital by changing oil and natural gas tax provisions. As such, the associations submitting these comments urge you to preserve the current tax treatment of capital formation and recovery provisions such as the expensing on intangible drilling costs (IDC), the Percentage Depletion deduction and the passive loss exception for working interests.

The Independent Petroleum Association of America (IPAA) and its Cooperating Associations submit the following comments in response to your request for stakeholder input to the Senate Finance Committee's bipartisan working groups on tax reform. These comments will be submitted to both the Business Income Tax Working Group as well as the Community Development & Infrastructure – both of which deal with provisions in the tax code that are relevant to America's independent oil and natural gas producers.

In addition to IPAA, these comments are submitted on behalf of the following organizations:

Arkansas Independent Producers and Royalty Owners Association
California Independent Petroleum Association
Coalbed Methane Association of Alabama
Colorado Oil & Gas Association
East Texas Producers & Royalty Owners Association
Eastern Kansas Oil & Gas Association
Florida Independent Petroleum Association
Idaho Petroleum Council
Illinois Oil & Gas Association
Independent Oil & Gas Association of New York

Independent Oil & Gas Association of West Virginia
Independent Oil Producers' Agency
Independent Oil Producers Association Tri-State
Independent Petroleum Association of New Mexico
Indiana Oil & Gas Association
Kansas Independent Oil & Gas Association
Kentucky Oil & Gas Association
Louisiana Oil & Gas Association
Michigan Oil & Gas Association
Mississippi Independent Producers & Royalty Association
Montana Petroleum Association
National Association of Royalty Owners
Nebraska Independent Oil & Gas Association
New Mexico Oil & Gas Association
New York State Oil Producers Association
North Dakota Petroleum Council
Northern Montana Oil and Gas Association
Ohio Oil & Gas Association
Oklahoma Independent Petroleum Association
Panhandle Producers & Royalty Owners Association
Pennsylvania Independent Oil & Gas Association
Permian Basin Petroleum Association
Petroleum Association of Wyoming
Southeastern Ohio Oil & Gas Association
Tennessee Oil & Gas Association
Texas Alliance of Energy Producers
Texas Oil and Gas Association
Texas Independent Producers and Royalty Owners Association
Utah Petroleum Association
Virginia Oil and Gas Association
West Virginia Oil and Natural Gas Association
Western Energy Alliance

In addition to the specific comments made herein, we support those comments submitted separately by the participants in these comments.

Collectively, these organizations represent the thousands of independent oil and natural gas explorers and producers, as well as the millions of royalty owners, in the United States that would be adversely affected by changes to IDC, the Percentage Depletion deduction and the Passive Loss Exception for Working Oil and Gas Interests. As defined by the Internal Revenue Code (IRC) Section 613(A), an independent producer is a producer that does not have more than $5 million in retail sales of oil and gas in a year or one that does not refine more than an average of 75,000 barrels per day of crude oil in a given year. Independent producers drill about 95 percent of American oil and natural gas wells, produce

about 56 percent of American oil, and more than 85 percent of American natural gas. Independent producers historically reinvest over 100 percent of American oil and natural gas cash flow back into new American production.

While there are hundreds of publicly traded companies that are independent producers, numerically, the overwhelming majority of independent producers are small businesses. For example, based upon a 2012 survey of IPAA's membership, the median IPAA member employs 12 full-time and 2 part-time employees. The typical independent producer has been in business for 23 years. As such, many independent producers are small, longstanding, community businesses.

Many independent producers are marginal well operators. Marginal wells are those with average production of not more than 15 barrels of oil or 90 Million cubic feet (Mcf) of natural gas, per day. An average marginal oil well in the United States produces about 2 barrels/day. Approximately 85 percent of all American oil wells are marginal wells, but they provide about 20 percent of American oil production. Approximately 73 percent of all American natural gas wells are marginal wells, providing 12 percent of American natural gas production. The marginal well base in the United States is unique and important. Unlike other countries, where governments generally own mineral rights and there is little incentive to keep marginal wells in operation, the United States has a strong marginal oil and natural gas base. The marginal base arises because typical oil and natural gas wells, after drilling and, if necessary, stimulation, begin with a few years of "flush" production. High initial production levels generally decline after the first few years to more moderate levels that are sustainable for decades. A long period of moderate to marginal production with a low rate of decline ensues, assuming wells are not made uneconomic because of government policies.

America's development of its oil and natural gas resources during recent years has been remarkable. The growth in American oil and natural gas production results in both economic and natural security benefits. With respect to American oil production, in 2014, crude oil production (including lease condensate) rose by the largest volume ever in its history (since recordkeeping began in 1900), to 1.2 million barrels per day, or 16.2 percent. More American oil production has resulted in improvements in American energy security. The changing dynamics with respect to oil imports provide one of the most striking examples. As recently as 2005, 60 percent of American oil consumption was supplied by net imports; in 2014 that share dropped to just under 27 percent.

The story of American natural gas and natural gas liquids production is equally bright. The story of American natural gas and natural gas liquids production is equally bright. The United States became the largest producer of natural gas in the world when it overtook the Russian Federation in 2009-2010. American output of natural gas liquids reached an all-time high in 2014, up over 77 percent from 2005. During the same period, U.S. marketed production of natural gas set another all-time record, at 27.3 trillion cubic feet, an increase of 44 percent.

Intangible Drilling Costs – IRC §263(c)

Expensing IDC has been part of the tax code since 1913. Found in section 263 of the IRC, IDC generally include any cost incurred that has no salvage value and is necessary for the drilling of wells or the preparation of wells for the production of natural gas or oil. IDC requires a cash investment equal to the deduction for IDC. Federal tax policy allows for the expensing of similar costs for a number of industry activities in addition to oil and natural gas production – including research and experimental expenditures and expenditures by farmers for fertilizer.

Only independent producers can fully expense IDC on American production. Loss of IDC for independent producers, especially at the current time when sales prices for oil and natural gas are likely to be low during the "flush" production years, will have significant effects on capital development budgets. A Raymond James analysis in 2009 reported that the loss of IDC would result in capital drilling budgets being reduced by 25 to 30 percent. This compares with information provided to IPAA by its members indicating that drilling budgets would be cut by 25 to 40 percent. Regardless of the exactness of the assessments, clearly, the consequences would be significant.

Additionally, changes to IDC expensing could be perilous for smaller independent producers. Unlike larger oil and natural gas companies, smaller independent producers are unable to attract financing from institutional investors or even community banks. The advent of Dodd-Frank has increasingly made lending to smaller producers impossible. As such, smaller producers must finance their drilling operations with cash flow generated from the wellhead. Changing the ability to immediately expense IDC will drastically curtail drilling budgets for all independent producers and will be especially impactful for smaller producers. Eliminating IDC would result less American investment and fewer wells being drilled in the United States each year.

Percentage Depletion Deduction – IRC §613 and §613A

The Percentage Depletion deduction is significant to independent producer's ability to reinvest capital into existing operations and the elimination of Percentage Depletion could jeopardize nearly 20 percent of American oil production and 12 percent of natural gas production.

All natural resources minerals are eligible for a Percentage Depletion income tax deduction. Percentage Depletion allows independent producers to reinvest cash into the maintenance and operational expenses of existing wells and redeploy capital to drill new wells. Percentage Depletion for natural gas and oil has been in the tax code since 1926 after Congress determined that relying solely on cost depletion was leading to the loss of important American mineral resources. The purpose of the Percentage Depletion deduction is to keep existing wells in operation longer – American production that would otherwise be lost forever. Unlike Percentage Depletion for all other resources, natural gas and oil percentage depletion is highly limited. It is available only for American production, only available to independent producers and for royalty owners, only available for the first 1000 barrels per day (6000 mcfd of natural

gas) of production, limited to the net income of a property and limited to 65 percent of the taxpayer's net income. Therefore, in addition to IDC expensing, Percentage Depletion is critical for smaller independent producer's ability to finance new drilling and maintain existing operations from cash flow. Percentage Depletion provides capital primarily for smaller independents and is particularly important for marginal well operators. These wells – that account for approximately 20 percent of American oil and 12 percent of American natural gas – are the most vulnerable economically. Percentage depletion is also available for oil and natural gas royalty income which benefits many small mineral owners without having a significant tax impact on tax revenues overall.

Input to IPAA from its operators who take Percentage Depletion indicates that the combined effect of eliminating IDC and Percentage Depletion would reduce drilling budgets in some cases by as much as half. Lowering the tax rate to 25 percent likely will not offset the impact of losing these provisions. Most royalty owners are currently in tax brackets below 25 percent and a reduction in the tax rate with a loss of Percentage Depletion would cause them to pay more income tax. The impact of a cut in drilling budgets means new production will not offset the natural decline in production from existing wells.

The elimination of tax provisions has been discussed in the context of offsetting lower tax rates. However, the amount gained by eliminating Percentage Depletion in minimal when compared to the amount needed to lower top tax rates from 35 percent to 25 percent. The Joint Committee on Taxation (JCT) tax expenditure calculations score the excess of Percentage over Cost Depletion for oil and natural gas (i.e., the score for eliminating Percentage Depletion, assuming Cost Depletion is retained) as $7.4 billion for five years (2014-18).[1] Similarly, the JCT revenue estimate for the Administrations FY2015 budget proposal to eliminate Percentage Depletion was $7.6 billion for 5 years (2014-19).[2] Despite these findings, an October 2014 IHS study determined that eliminating Percentage Depletion will, in fact, result in a net loss of $2.5 billion in tax revenue to the federal government over the next decade. [3]

Congress' choice is straightforward: risk reduction of American oil production by 20 percent and its natural gas production by 12 percent and suffer a loss in federal tax revenue or retain the current historic tax policies that have encouraged American production.

Passive Loss Exception for Oil and Gas Working Interests – IRC §469

Maintaining the Passive Loss Exception for Oil and Gas Working Interests is critical to many independent producers' ability to raise capital.

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[1] Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2014-2018* (August 5, 2014), JCX-97-14.

[2] Joint Committee on Taxation, Estimated Effects of the Revenue Provisions Contained in The President's Fiscal Year 2015 Budget Proposal (April 15, 2014), JCX-36-14.

[3] IHS Economics & Country Risk, *The Economic Impact of Eliminating the Percentage Depletion Allowance: National, State and Sector Level Analysis* (October 2014) available at http://nswa.us/page_images/1421176174.pdf.

The Passive Loss Exception for Oil and Gas Working Interests enables working interest owners in oil and natural gas operations to achieve some parity between their investments and those of corporate shareholders. By counting any working investment losses as active instead of passive, investors are able to treat the normal business deductions from their investment in the same way a corporation would.

The Tax Reform Act of 1986 divided investment income/expense into two baskets – active and passive. In doing so, the Tax Reform Act of 1986 provided an exception for working interests in natural gas and oil from being part of the passive income basket and, if a loss resulted (from expenditures for drilling wells), it was deemed to be an active loss that could be used to offset active income as long as the investor's liabilities were not limited. Natural gas and oil development require large sums of capital and producers frequently join together to diversify risk. Additionally, natural gas and oil operators have sought individual investors to contribute capital and share the risk of drilling wells. Many American wells today are drilled by small and independent companies, many of which depend on individual investors.

However, not any investor may use the Passive Loss Exception for Working Oil and Gas Interests. The key test is whether the investor is "materially involved." The Internal Revenue Service has set out a series of tests to determine material involvement but, generally, material involvement is on a "regular, continuous and substantial" basis.[4] Importantly, investors are only allowed a deduction for the actual expenses incurred and paid by the investor with respect to their working interest.

There is no sound reason for Congress to enact tax rules that would discourage individual investors from continuing to participate in this system. Congress applied the passive loss rules only to individuals and not to corporations. The repeal of the Passive Loss Exception for Working Oil and Gas Interests, therefore, would senselessly drive natural gas and oil investments away from individuals and toward corporations. There is no apparent reason why Congress would or should favor corporate ownership over individual ownership of working interests. Furthermore, since Alternative Minimum Tax (AMT) restrictions apply to IDC of individual working interest investors, the application of the passive loss rules to those investors is unnecessary and excessive.

The elimination of the Passive Loss Exception for Working Oil and Gas Interests would have no meaningful score to be used to lower tax rates. In fact, for the JCT tax expenditure calculations for the Passive Loss Exception for Working Oil and Gas Interests, JCT states that it does not consider this provision as a tax expenditure.[5] Further evidence for the lack of meaningful revenue for base broadening is supplied by the JCT Revenue Estimate for the Administration's FY2015 budget proposal,

[4] Treas. Reg § 1.469-5T(a)(7). For full list see Treas. Reg § 1.469-5T(a)(1) through (7).

[5] Joint Committee on Taxation, Estimates of Federal Tax Expenditures for Fiscal Years 2014-2018 (August 5, 2014) JCX-97-14.

which proposed eliminating the Passive Loss Exception for Working Oil and Gas Interests. JCT estimated that this budget proposal would score $110 million over five years (2014-2019).[6]

In sum, to qualify for the exception, the taxpayer must have liability exposure, materially participate and definitely be at risk for any losses. If income/loss, arising from natural gas and oil working interests, is treated as passive income/loss, the primary income tax incentive for taxpayers to risk an investment in natural gas and oil development would be significantly diminished. In today's banking climate, smaller producers find banks uninterested or incapable of providing capital; taking private investors away will further exacerbate the challenge of raising capital to sustain American marginal well production.

Conclusions

Therefore, the Senate Committee on Finance faces a key question: should policymakers promote increased American oil and natural gas production and the corresponding economic benefits to America or should Congress enact policies that will return the United States to the days of increasing reliance on imported energy? The associations listed in these comments urge the Committee to support the retention of IDC, the Percentage Depletion deduction and the Passive Loss Exception for Working Oil and Gas Interests that will enhance American energy production.

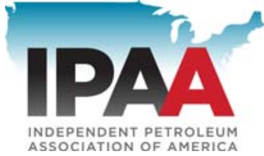
If you require additional information please contact Matt Kellogg (mkellogg@ipaa.org) or Lee Fuller (lfuller@ipaa.org) at 202.857.4722.

Sincerely,

Barry Russell
President and CEO
Independent Petroleum Association of America

Enclosures

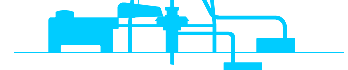
[6] Joint Committee on Taxation, Estimated Effects of the Revenue Provisions Contained in The President's Fiscal Year 2015 Budget Proposal (April 15, 2014), JCX-36-14.



Drilling and Development Costs

The 50 largest independent producers are reinvesting 150 percent of their domestic cash flow back into domestic projects.

John S. Herold



Since 1913, a drilling and development costs deduction has been allowed as an ordinary and necessary business expense for those costs where there is no remaining equipment to value (salvage value) when an oil or natural gas well is completed. Because there is nothing tangible to value, these costs are generally called “intangible drilling costs” or IDCs. For the past 30 years, American tax policy has shortened the depreciation period for equipment to allow capital to be recovered and reinvested in new American projects. Like other rapid depreciation schedules in the tax code, the drilling cost deduction allows for investment capital to be immediately recovered and encourages its reinvestment. It is not a tax subsidy or a “loophole”. For American independent producers it has resulted in facilitating reinvestment in new American projects at rates up to 150 percent of American cash flow.

Issues

Within the past decade the combination of advanced horizontal drilling techniques and sophisticated hydraulic fracturing opened the development of both shale gas and shale oil formations. These American resources can provide up to 100 years of natural gas supply and generated the first increase in American oil production in the past two decades. Clearly, while America has been producing these resources for 150 years, today’s production will reflect a vastly different onshore industry than in the past. Similarly, the industry will continue to advance its technology in the offshore where the challenges of deeper formations and deeper water depths have driven significant changes in the past twenty years. What is common to developing all of these resources is the need for capital. In 2010, onshore independent producer capital expenditures were about $62.6 billion. Similarly, offshore independent producer capital expenditures were about $11.8 billion in the federal offshore in 2008.

Independent producers have a history of investing in America. Recent assessments have concluded independents reinvesting up to 150 percent of their American cash flow back into new American projects. And, independents drill 95 percent of wells in the United States. The faster that producers recover the capital invested in projects, the faster it can be reinvested. For independent producers since 1913 – at the inception of the tax code – drilling costs[1] for the elements that are not a part of the final operating well could be deducted in the year they are incurred (expensed). These costs can be 60 to 90 percent of the development costs of a well – with shale wells on the high end. Clearly, putting this capital back into new production means more jobs, more production and more federal and state taxes.

Studies have addressed the role of independent producers in the US economy – both onshore and offshore. The onshore analysis showed that independent producers support almost 4 million direct, indirect and induced jobs (3% of US jobs) with the upstream component accounting for 2.1 million of those jobs. The offshore analysis showed that independent producers supported over 200,000 direct, indirect and induced jobs in 2009 in the Gulf of Mexico and the Gulf states. These investments also mean taxes to the federal and state governments. Onshore upstream taxes totaled $67.7 billion in 2010 while taxes resulting from offshore operations were $7.0 billion in 2009.

Drilling and Development Costs (Continued)

Status

A number of tax proposals target drilling costs, sacrificing a critical element of the nation's tax policy that encourages American natural gas and oil exploration and production. The Obama Administration proposes to repeal expensing of drilling costs with an estimated revenue increase of $13.7 billion over a ten year period.[2] Other broader tax reform proposals would eliminate the tax deduction to pay for lower tax rates. The loss of the IDC deduction would result in dramatic curtailment of American oil and natural gas development.

Wood Mackenzie recently completed an analysis of the impacts of changing the IDC deductibility.[3] Among its key conclusions, it determined that the US would lose 3.8 million B/D of oil equivalent production by 2023, employment losses of 233,000 by 2019 and lost industry investment averaging $40 billion/year. After 2017, at least 8,000 fewer wells would be drilled annually – a 15-20 percent loss of activity. This loss of development activity will also diminish federal and state revenues. An earlier study[4] concluded that in 2011 the onshore independent producer industry paid approximately $36.3 billion in federal taxes (corporate and personal) with an expectation that these tax payments will grow to $53.4 billion in 2020. However, with lower capital investment, federal taxes would be reduced by more than $18 billion over the ten year period from just onshore independent producers alone. If midstream and downstream impacts as well as offshore independent producers are considered, lost federal revenues would exceed $31 billion. Similarly, state and local tax revenues would fall by about $26 billion imposing greater burdens on communities and subsequently on the federal treasury. These lost revenues significantly exceed the revenue gains projected by the Administration.

Proposals to eliminate the deductibility of IDCs should be rejected because the consequence would be to reduce investment in new American natural gas and oil development – investments that produce the natural gas essential to a clean energy future, the natural gas necessary to grow solar and wind energy, the oil to reduce our dependency on foreign sources.

August 2013

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[1]Drilling and Development Costs (IDCs) include all expenditures made by an operator for wages, fuel, repairs, hauling, supplies, etc., incident to and necessary for the drilling of wells and the preparation of wells for the production of natural gas and oil. In addition, IDCs include the cost to operators of any drilling or development work[1] done by contractors under any form of contract (including a turnkey contract). Such work includes labor, fuel, repairs, hauling, and supplies which are used in the drilling, shooting, and cleaning of wells; in such clearing of ground, draining, road making, surveying, and geological works (as are necessary in preparation for the drilling of wells); and in the construction of such derricks, tanks, pipelines, and other physical structures as are necessary for the drilling of wells and the preparation of wells for the production of oil and gas. Generally, IDCs do not include expenses for items which have a salvage value (such as pipes and casings), or items which are part of the acquisition price of an interest in the property.

If an election to expense IDCs is made, the taxpayer deducts the amount of the IDCs as an expense in the taxable year the cost is paid or incurred. Generally, if IDCs are not expensed, but are capitalized, they may be recovered through depletion or depreciation, as appropriate. Or, in the case of a nonproductive well ("dry hole"), they may be deducted, at the election of the operator. In the case of an integrated oil company that has elected to expense IDCs, 30 percent of the IDCs on productive wells must be capitalized and amortized over a 60-month period. Notwithstanding the fact that a taxpayer has made the election to deduct IDCs, the Tax Code provides an additional election under which the taxpayer is allowed to capitalize and amortize certain IDCs over a 60-month period beginning with the month the expenditure was paid or incurred. This rule applies on an expenditure-by-expenditure basis; that is, for any particular taxable year, a taxpayer may deduct some portion of its IDCs and capitalize the rest under this provision. This allows the taxpayer to reduce or eliminate the IDC adjustments or preferences under the alternative minimum tax. The election to deduct IDCs applies only to those IDCs associated with American properties. For this purpose, the United States includes certain wells drilled offshore.

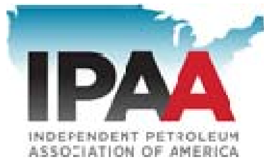
AMT Treatment of IDCs

Also as discussed above, in computing its regular tax, a taxpayer who pays or incurs IDCs in the development of American natural gas or oil properties may elect to either expense or capitalize these amounts. The difference between the amount of a taxpayer's IDC deductions and the amount which would have been currently deductible had IDCs been capitalized and recovered over a 10-year period may constitute an item of tax preference for the Alternative Minimum Tax (AMT) to the extent that this amount exceeds 65 percent of the taxpayer's net income from natural gas and oil properties for the taxable year (the "excess IDC preference").

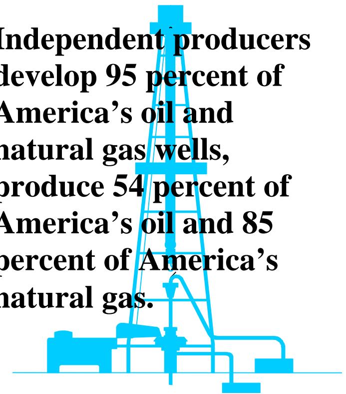
For taxpayers other than integrated oil companies, the Energy Policy Act of 1992 repealed the excess IDC preference for IDCs related to natural gas and oil wells for taxable years beginning after 1992. The repeal of the excess IDC preference, however, may not result in the reduction of the amount of the taxpayer's Alternative Minimum Taxable Income (AMTI) by more than 40 percent of the amount that the taxpayer's AMTI would have been had the excess IDC preference not been repealed.

In addition, for purposes of computing the an integrated oil company's adjusted current earnings (ACE) adjustment to the AMT, IDCs are capitalized and amortized over the 60-month period beginning with the month in which they are paid or incurred. The ACE preference does not apply to independent natural gas and oil producers since enactment of the Energy Policy Act of 1992.

[2] Joint Committee on Taxation estimate, May 2013.
[3] *Impacts of delaying IDC deductibility (2014-2025)*, Wood Mackenzie, July 2013.
[4] *The Economic Contribution of the Onshore Independent Oil and Natural Gas Producers to the U.S. Economy*, IHS Global Insight (USA), Inc., April 2011



Percentage Depletion



Depletion, like depreciation, allows for the recovery of capital investment over time. Percentage depletion is used for most mineral resources including oil and natural gas. It is a tax deduction calculated by applying the allowable percentage to the gross income from a property. For oil and natural gas the allowable percentage is 15 percent.[1]

A part of the tax code since 1926, percentage depletion has changed over time. Current tax law limits the use of percentage depletion of oil and gas in several ways. First, the percentage depletion allowance may only be taken by independent producers and royalty owners and not by integrated oil companies. Second, depletion may only be claimed up to specific daily American production levels of 1,000 barrels of oil or 6,000 mcf of natural gas. Third, the deduction is limited to 65% of net taxable income. Fourth, the net income limitation requires percentage depletion to be calculated on a property-by-property basis.[2] It prohibits percentage depletion to the extent it exceeds the net income from a particular property. These limitations apply both for regular and alternative minimum tax purposes. Percentage depletion in excess of the 65 percent limit may be carried over to future years until it is fully utilized.

Despite these limitations, percentage depletion remains an important factor in the economics of American oil and natural gas production. Most independent producers do not exceed the 1000 barrel per day limitation. Yet, these producers are a significant component of America's oil production. For example, they are the predominant operators of America's marginal wells. Over 85 percent of America's oil wells are marginal wells – producing less than 15 barrels per day. Yet, these wells produce about 20 percent of American oil production. About 75 percent of American natural gas wells are marginal wells, producing approximately 12 percent of American natural gas. Marginal wells are unique to the United States; other countries shut down these small operations. Once shut down, they will never be opened again – it is too costly. Even keeping them operating is expensive – they must be periodically reworked, their produced water (around 9 of every 10 barrels produced) must be disposed properly, the electricity costs to run their pumps must be paid. The revenues retained by percentage depletion are essential to meet these costs. For larger wells, percentage depletion provides more revenues to be used to find new oil and natural gas in the United States. Independent producers historically invest more than their cash flow back into projects.

Action Needed

The Obama Administration budget proposal would repeal percentage depletion of oil and natural gas. Loss of percentage depletion would adversely affect American oil and natural gas production. Lost American production runs counter to America's energy security needs, America's move toward cleaner energy and even the development of alternative energy sources like wind and solar that require natural gas backup when they cannot generate energy. The Obama Administration proposal should be rejected.

September 2014

[1] For marginal wells the allowable percentage is increased (from the general rate of 15 percent) by one percent for each whole dollar that the average price of crude oil for the immediately preceding calendar year is less than $20 per barrel. In no event may the rate of percentage depletion under this provision exceed 25 percent for any taxable year. The term "marginal production" for this purpose is domestic crude oil or domestic natural gas which is produced during any taxable year from a property which (1) is a stripper well property for the calendar year in which the taxable year begins, or (2) is a property substantially all of the production from which during such calendar year is heavy oil (i.e., oil that has a weighted average gravity of 20 degrees API or less corrected to 60 degrees Fahrenheit). A stripper well property is any oil or gas property which produces a daily average of 15 or less equivalent barrels of oil and gas per producing oil or gas well on such property in the calendar year during which the taxpayer's taxable year begins.

[2] The net income limitation for marginal wells is suspended during 2009.

Passive Loss Exception

Why is the Passive Loss Exception an Issue?

The passive loss exception enables working interest owners in oil and natural gas production to achieve some parity between their investments and those of corporate shareholders. By counting any working interest investment losses as active instead of passive, investors are able to treat the normal business deductions from their investment in the same way that a corporation would. But the Obama Administration would repeal the passive loss exception.

Why was the Passive Loss Exception Created?

The passive loss exception reflects Congressional recognition that the Tax Reform Act of 1986 created an inequity. The Tax Reform Act divided investment income/loss into two baskets – active and passive. Moreover, the passive loss rules apply only to individuals; corporations pass the same deductions to shareholders as part of the

overall value of the stock. If income/loss, arising from natural gas and oil working interests, were treated as passive income/loss, taxpayers would be significantly less willing to risk an investment in natural gas and oil development.

Most American wells today are drilled by small and independent companies, many of which depend on individual investors. There is no sound reason for Congress to enact tax rules that would discourage individual investors from continuing to participate in energy investments. The repeal of the working interest rule, therefore, would senselessly drive natural gas and oil investments away from individuals and toward corporations.

What is Active Versus Passive?

Passive income and loss are based on an activity in which the investor is not "materially" involved. According to the IRS, material involvement is on a "regular, continuous, and substantial" basis. For example, if an investor buys shares in a rental property – in which he or she is not actively involved in operating or maintaining – the investment is considered passive. This is the same for limited partnerships – a limited partner invests in the partnership but is not involved in the day to day activity and operations.

Limited partners are vital to the investment in oil and natural gas, spurring investment in American energy. Unfortunately, drilling a well does not guarantee resource production; yet the capital costs of exploration – successful or not – are extremely high. Because of the passive loss exception, working interests in oil and natural gas are removed from the passive income basket. In other words, all oil and gas working interests are considered active, even if the investor is not the operator of the drilling and production operations.

Importantly, investors in working interests are engaged in the very real activity of exploring for and developing oil and natural gas resources. Moreover, these investors are allowed deductions only for the actual expenses incurred and paid by them with respect their working interests. Working interest owners cannot deduct any expenses that have not actually been incurred by them and for which they are not entirely liable. By defining this income/loss as active, these investors and partners are able to continue advancing American energy exploration and production.

Why is Passive Loss Exception Important to American Energy?

The passive loss exception enables continued investment into American energy exploration, supporting the small businesses and the countless other industries and consumers who benefit from affordable, secure American energy. By allowing individual investors to participate actively in oil and natural gas production ventures, investment is able to continue where it would otherwise be lost.