Intangible Drilling & Completion Costs (IDC): US Tax Deduction

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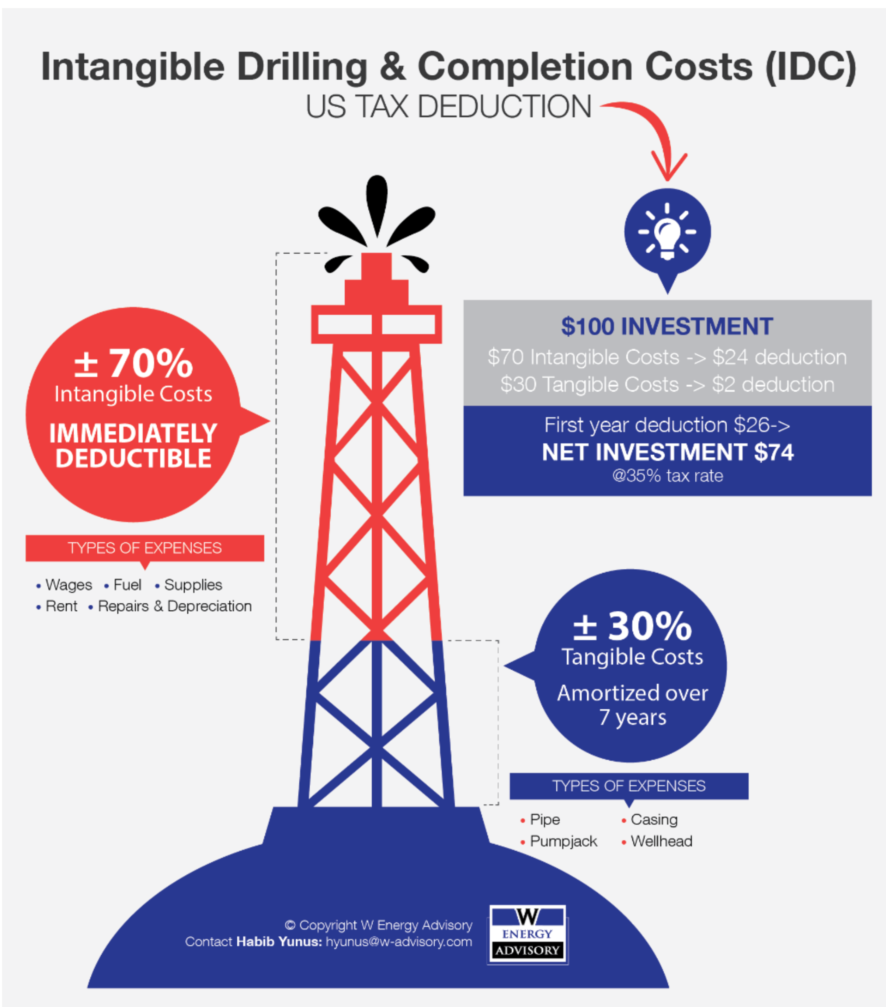
Summary

- The IDC deduction has been allowed in the US since 1913 in order to attract investment capital to the high-risk business of oil and gas exploration
- IDC can be deducted in the year incurred, whereas tangible drilling costs are amortized over 7 years
- Owners of working interests in wells can typically deduct 60-80% of total well cost as IDC
- The IDC deduction can grant a $24 dollar-for-dollar tax reduction for every $100 invested, reducing the net investment to $75
- Another way that most investors like to think is that the $24 IDC deduction can be used to immediately offset other income



Overview

- Operators of a domestic US oil, gas or geothermal well may elect to currently deduct intangible drilling and development costs rather than charge such costs to capital, recoverable through depletion or depreciation.
- Intangible drilling costs are defined as costs related to drilling and necessary for the preparation of wells for production, but that have no salvageable value.
- The election is binding upon future years.
- An integrated oil company must reduce the allowable IDC by 30%.
- An independent producer can expense the full IDC amount.

History

- In 1918, the IRS clarified the ability to either deduct or capitalize certain drilling expenses.
- Regulations issued in 1919 combined the oil and natural gas expense recovery provisions into a more succinct election:

  > "Such incidental expenses as are paid for wages, fuel, repairs, hauling, etc., in connection with the exploration of the property, drilling of wells, building of pipe lines, and development of the property may at the option of the taxpayer be deducted as an operating expense or charged to the capital account returnable through depletion"

- This language was retained in the regulations until in 1933, when the expression "intangible drilling and development costs" was first used in reference to the allowance of the deduction for expenditures 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 oil or gas. . . ."
- In connection with the Revenue Bill of 1942, Congress explicitly reaffirmed the treatment of oil and natural gas drilling and development costs.
- Furthermore, in 1954, Congress retained the option to expense IDCs incurred by the operator. [i]

Economic Impact

According to the Joint Committee on Taxation (JCT), the tax break for intangible drilling will cost roughly $1 billion in 2013, and $16 billion over the next decade. This is the largest tax preference specifically for oil and gas and totaled about 8 percent of the total value of tax preferences for energy and natural resources in 2013. In contrast, expensing for exploration and development costs for nonfuel minerals (like coal) cost $0.1 billion in 2013, and $1 billion over the next decade.[ii]

Tax Year

IRS code section 461 has a special provision that allows IDC's paid before 12/31 of any given tax year to still be deducted in such tax year provided the drilling of the well commences before the close of the 90th day after the close of the taxable year (3/31) and other certain conditions are met as per the regulations.

Active vs. Passive Income

The US tax code specifies that a working interest (as opposed to a royalty interest) in an oil and gas well is not considered to be a passive activity. This means that all net losses are active income incurred in conjunction with well-head production and can be offset against other forms of income such as wages, interest and capital gains.

Drilling Carry

In general, the taxpayer can take the IDC in proportion to his share of costs paid, which may not be the same as the WI. For example, if a WI holder paid 1/3 of the cost for a ¼ interest, the WI holder would be eligible for 1/3 of the IDC.

This can become more complicated and will vary if there are payout terms that add another layer to the complexity. In that case, please contact hyunus@w-advisory.com for assistance.

Foreign wells

Operators may not deduct IDCs for wells located outside the US. Such costs must be recovered over a 10-year straight-line amortization schedule or added to the adjusted basis of the property for cost depletion

Secondary Recovery wells

Wells recognized as secondary recovery, such as water and gas injection wells are costs incurred in "the preparation of [oil] wells for production," and the cost of such wells is subject to the IDC.[iii]

Water source wells

Drilling water wells to provide water in drilling oil and gas wells, or for hydraulic fracturing would preparation for production and should qualify as an IDC.

Drilling water wells to use in secondary recovery will likely need to be capitalized as lease and well equipment.

Saltwater disposal wells (SWD)

Wells drilled for the purpose of water disposal are typically capitalized as lease and well equipment because they are related to operations, not to the drilling or an oil or gas well, or preparing it for production.[iv]

IDC Recapture

For property placed in service after 1986, when oil, gas or mineral properties are disposed of, certain expensed costs are recaptured as ordinary income. Exploration and intangible drilling and development costs are recaptured to the extent that they would have been included in the adjusted basis of the property if they and not been deducted. Depletion is subject to recapture to the extent that it reduced the adjusted basis of the property.

Alternative Minimum Tax (AMT)

All excess intangible drilling costs have been specifically exempted as a "preference item" on the alternative minimum tax return.

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[i] Wood Mackenzie: Impacts of delaying IDC deductibility (2014-2025); July 2013

[ii] http://crfb.org/blogs/tax-break-down-intangible-drilling-costs

[iii] KPMG: A Primer on Domestic Oil and Gas, Part II: Intangible Drilling and Development Costs; Page Oil Co. v. Commissioner, 41 B.T.A. 952 (1940), *nonacq*. 1940-2 C.B. 13, *aff'd on other issues*, 129 F.2d 748 (2d Cir. 1942); Rev. Rul. 69-583, 1969-2 C.B. 41; G.C.M. 39619 (Mar. 19. 1987).

[iv] Rev. Rul. 70-414.