Center for American Progress

It Is Time to Phase Out 9 Unnecessary Oil and Gas Tax Breaks

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The investment tax credit, or ITC, and production tax credit, or PTC, for clean energy have played an essential role in expediting the deployment of wind, solar, and other forms of clean energy in the United States. In December 2015, the U.S. Congress voted to extend the PTC and ITC. As part of the agreement, however, Congress decided to phase out these tax credits over time.[1] This raises an important question, one asked by Sen. Brian Schatz (D-HI) in February:[2] If policymakers phase out tax credits for clean energy, shouldn't they do the same for the billions of dollars in tax breaks for the oil and gas industry?

This fact sheet highlights nine tax breaks that should be phased out. They subsidize the oil and gas industry's operations from beginning to end—from acquisition of the resource to extraction.

Deductions for the costs of drilling wells

Location in tax code: 26 U.S.C. § 263(c)

Amount saved by repealing: $13.1 billion between 2016 and 2026[3]

As a general practice, businesses deduct business costs from their income. But for large capital projects, they do so over the lifetime of the asset or project, not during the period in which the cost was incurred. Oil and gas companies, however, can deduct intangible drilling costs—nearly all of the expenditures a company makes to prepare a well for production—upfront, which can lower their taxable income significantly. Independent oil and gas producers can deduct 100 percent of their intangible drilling costs in the first year. Integrated oil companies can deduct 70 percent of these costs in the first year and then amortize the remaining 30 percent over five years.[4]

Domestic manufacturing deduction for oil and gas production

Location in tax code: 26 U.S.C. § 199

Amount saved by repealing: $10.9 billion between 2016 and 2026

In 2004, Congress passed the American Jobs Creation Act, which included a tax deduction designed to incentivize domestic manufacturing in the United States and keep certain industries from moving abroad.[5] Oil and gas producers can deduct 6 percent of taxable income derived from qualified domestic production activities.[6] This tax break is a handout to the industry as domestic oil and gas production—by definition—cannot move abroad.

Deductions for the depletion of oil and gas deposits

Location in tax code: 26 U.S.C. § 613A(c)(1)

Amount saved by repealing: $12.1 billion between 2016 and 2026

The tax code also allows certain oil and gas companies to recover costs associated with the depletion of the natural resource—the oil or gas deposit. The depletion allowance permits royalty owners and independent oil and gas producers to deduct 15 percent of the gross income from oil and gas produced from a well each year, rather than a deduction based on the actual exhaustion of the resource each year. Operators of low-producing marginal wells are permitted to deduct more than 15 percent—based on a statutory formula linked to the price of crude—and to deduct more than their net income from the property. These producers may be able to continue claiming the depletion deduction even after they have recovered the costs of acquiring and developing the property. This means that other taxpayers are effectively subsidizing their income.[7]

Deductions for the depletion of oil shale deposits

Location in tax code: 26 U.S.C. § 613(b)(2)(B)

Amount saved by repealing: The U.S. Treasury would save $840 million between 2016 and 2026 by repealing the depletion deduction for all hard mineral fossil fuels, of which oil shale is one. The amount applying to oil shale alone is unknown.

Oil shale[8]—located primarily in Utah and Colorado—is expensive to extract and process, is particularly harmful to the environment, and has yet to reach commercial scale in the United States.[9] Despite these drawbacks, companies engaged in oil shale exploration and development can claim a 15 percent depletion allowance on income generated from these activities. Consequently, taxpayers are subsidizing environmentally harmful projects that are not needed, given high-levels of oil production elsewhere in the United States.

Deductions for the costs of oil shale exploration and development

Location in tax code: 26 U.S.C. § 617

Amount saved by repealing: The U.S. Treasury would save $768 million between 2016 and 2026 by repealing this tax preference for certain mining exploration expenditures, including expenditures for oil shale. The amount applying to oil shale alone is unknown.

This tax preference allows oil and gas companies to deduct the costs of exploring and developing new domestic oil shale fields in the same tax year that the costs were incurred, rather than when those expenditures actually generate income. This means that companies engaged in oil shale production can incur costs exploring for deposits and deduct those costs from other income, whether or not they ever generate income on the property. This transfers the risk from the company to the taxpayer.

Amortization of geological and geophysical expenditures

Location in tax code: 26 U.S.C. § 167(h)

Amount saved: $1.3 billion between 2016 and 2026[10]

Oil and gas companies use geological and geophysical surveys in order to locate and assess potential mineral deposits. Rather than amortizing these expenses over the lifetime of the project, independent oil and gas producers are allowed to write off these expenses over two years, and large integrated oil and gas companies can use seven years.[11] This lowers the companies' taxable income.

Deductions for tertiary injectants

Location in tax code: 26 U.S.C. § 193

Amount saved by repealing: $100 million between 2016 and 2026

This tax deduction allows oil and gas companies to deduct the costs of using tertiary recovery methods, processes in which companies inject fluids and gases into older wells in order to recover additional oil. Companies can deduct the costs in the year they are incurred rather than when the expenditures generate income, thereby lowering their taxable income.[12]

Exception to passive loss limitation for working interests in oil and natural gas properties

Location in tax code: 26 U.S.C. § 469(c)(3)

Amount saved by repealing: $310 million between 2016 and 2026

The passive loss limitation allows taxpayers to deduct losses from passive activities—business activities in which a taxpayer has an economic interest but does not materially participate—against income from those activities. If the deductions exceed the passive income, the taxpayer must carry the remaining loss over to the next tax year. This rule is intended to prevent investors from using investments as tax shelters. Certain oil and gas interests, however, are exempt from this limitation and can use passive losses to reduce taxes on other business income.[13]

Marginal wells tax credit

Location in tax code: 26 U.S.C. § 45I

Amount saved by repealing: $0, unless oil and natural gas prices fall below a certain threshold

Marginal wells are those that produce a relatively small amount of oil and natural gas; as a result, they are among the least cost-effective wells to operate. This tax credit allows oil and gas companies to claim a tax credit for low-producing wells when the prices for oil or natural gas dip below a threshold.[14] Since this credit's enactment in 2004, prices have not been low enough to trigger this tax credit. Given consistently low natural gas prices in recent years, some industry observers speculate that oil and gas companies may be able to claim this credit for the first time in 2016.[15]

Repealing these nine tax breaks would, at minimum, save the U.S. Treasury $37.7 billion over 10 years.[16]

Endnotes

1 For a description of the tax credits and their revised schedule, see U.S. Department of Energy, "Renewable Electricity Production Tax Credit," available at http://energy.gov/savings/renewable-electricity-production-tax-credit-ptc (last accessed May 2016); U.S. Department of Energy, "Business Energy Investment Tax Credit," available at http://energy.gov/savings/business-energy-investment-tax-credit-itc (last accessed May 2016).

2 Office of Sen. Brian Schatz, "Schatz: We Need a Level Playing Field on Tax Policy for Clean Energy and Fossil Fuels," Press release, February 2, 2016. In February 2016, Sen. Schatz offered an amendment to the Energy Policy Modernization Act to phase out several tax breaks for fossil fuels on a similar schedule as the clean energy tax breaks. The Senate voted down the amendment 45-50. U.S. Senate, "On the Amendment (Schatz Amdt. No. 3176)," February 2, 2016, available at http://www.senate.gov/legislative/LIS/roll_call_lists/roll_call_vote_cfm.cfm?congress=114&session=2&vote=00014.

3 Unless otherwise noted, all cost savings figures were obtained from The Joint Committee on Taxation, "Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2017 Budget Proposal" (2016), available at https://www.jct.gov/publications.html?func=startdown&id=4902.

4 American Petroleum Institute, "Expensing Intangible Drilling Costs," available at http://www.api.org/~/media/files/policy/taxes/repeal_expensing_of_intangible_drilling_cost.pdf (last accessed May 2016).

5 Congressional Research Service, "The Section 199 Production Activities Deduction: Background and Analysis" (2012).

6 U.S. Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals* (2016), p. 92, available at https://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2017.pdf.

7 Ibid., p.91–92.

8 Oil shale is rock that contains kerogen, a precursor to oil that can be processed into oil; shale oil, in contrast, is oil trapped in tight geological formations that requires hydraulic fracturing to release.

9 Western Resource Advocates, "Oil Shale and Tar Sands – Two of the Most Polluting Fuels on the Planet," available at http://westernresourceadvocates.org/western-lands/stopping-oil-shale-and-tar-sands/ (last accessed May 2016).

10 These savings are for increasing the geological and geophysical amortization period for independent producers from two years to seven years.

11 U.S. Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals*, p. 92.

12 Ibid., p. 91.

13 Ibid.

14 Ibid., pp. 89–90.

15 Aaron Davis, "Small-well producers see tax relief amid oil price drop," *Amarillo Globe-News*, March 17, 2016.

16 This total does not include any revenue generated from repealing the tax breaks for oil shale or the marginal well credit since the amounts are unknown.