Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Calderon	Analyst:	Jahna Alvarado	Bill Number:	ABX3 30
Related Bills:	See Legislative History	Telephone:	845-5683	Introduced Date:	September 5, 2008
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Enhanced Oil Recovery Credit & Percentage Depletion Deduction / Repeal Credit & Disallow Deduction for Taxpayers Engaged in Oil Production Business

SUMMARY

This bill would repeal the enhanced oil recovery (EOR) credit and disallow the percentage-depletion deduction for any trade or business engaged in the oil production business.

PURPOSE OF THE BILL

According to the author's office, the purpose of this bill is to address the fiscal emergency declared by the Governor on January 10, 2008.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would become effective on the date of enactment and operative for taxable years beginning on or after January 1, 2008.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

Enhanced Oil Recovery Credit

Federal Law

Internal Revenue Code (IRC) section 43 generally provides an EOR credit for any taxable year in an amount equal to 15% of the taxpayer's "qualified enhanced oil recovery costs" for such taxable year.

Board Position:			Department Director	Date
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"Qualified Enhanced Oil Recovery Costs" means any of the following:

- Any amount paid or incurred during the taxable year for tangible property that –
  - Is an integral part of a qualified enhanced oil recovery project, and
  - Can be depreciated or amortized.

- Any intangible drilling and development costs that –
  - Are paid or incurred in connection with a qualified enhanced oil recovery project, and
  - The taxpayer may make an election under IRC section 263(c) for the taxable year.

- Any qualified tertiary injectant expenses (as defined in IRC section 193(b)) that are paid or incurred in connection with a qualified EOR project and for which a deduction is allowable for the taxable year.

- Any amount that is paid or incurred during the taxable year to construct a gas treatment plant that—
  - Is located in the area of the United States (within the meaning of IRC section 638(1)) lying north of 64 degrees North latitude.
  - Prepares Alaska natural gas for transportation through a pipeline with a capacity of at least 2 trillion Btu of natural gas per day, and
  - Produces carbon dioxide that is injected into hydrocarbon-bearing geological formations.

"Qualified enhanced oil recovery project" means any project—

- That involves the application (in accordance with sound engineering principles) of one or more tertiary recovery methods (as defined in IRC section 193(b)(3)), which can reasonably be expected to result in more than an insignificant increase in the amount of crude oil which will ultimately be recovered,
- That is located within the United States (within the meaning of IRC section 638(1)); and
- With respect to which the first injection of liquids, gases, or other matter, that commences after December 31, 1990.

Certification Requirement - A project shall not be treated as a qualified enhanced oil recovery project unless the operator submits to the Secretary of the Treasury (at such times and in such manner as the Secretary provides) a certification from a petroleum engineer that the project meets (and continues to meet) the requirements specified above.

Disallowance of Deduction - Any deduction allowable for any costs taken into account in computing the amount of the credit determined shall be reduced by the amount of such credit attributable to such costs.

Basis Adjustments - If a credit is determined under this section for any expenditure with respect to any property, the increase in the basis of such property which would (but for this credit) result from such expenditure shall be reduced by the amount of the credit so allowed.

Phase-Out of Credit

The amount of credit is reduced (i.e. phased-out) when the “reference price” exceeds a specified “threshold” amount.

- The “reference price” is the annual average wellhead price for a barrel of oil for the last calendar year that ended before the taxable year in question.[1]
- The “threshold” amount was first established in 1990 at $28 and is adjusted every year by an inflation-adjustment factor.[2]

The amount of credit phased out is the excess of the “reference price” over the “threshold” amount divided by $6. In any year that the “reference price” exceeds the “threshold” amount by more than $6, the credit is completely phased out.

For example, for taxable year 2006, the phase out is computed by using the 2006 calendar-year “reference price” of $59.68, and the 2006 calendar-year “threshold” amount of $39.82.[3] Because the “reference price” ($59.68) exceeds the threshold amount ($ 39.82) by $19.86, the credit is completely phased out. The computation is:

$59.68 - $39.82 = $19.86 / 6 = 331%
(The credit is phased out for any percentage over 100%.)

Due to the high price of oil in 2007 and 2008, the credit is completely phased out in those years.

State Law

The California credit[4] is generally the same as the federal credit except for the following:

- The California credit is equal to 5% of the qualified enhanced oil recovery costs for qualified oil recovery projects located in California. The federal credit is equal to 15% of the qualified enhanced oil recovery costs for qualified oil recovery projects located in the United States. This includes the seabed and subsoil adjacent to the territorial waters of the United States as defined under IRC section 638(1).

- California does not allow the credit for the following taxpayers:[5]
    - Taxpayers who are retailers of oil that directly (or through a related person) sell oil, excluding bulk sales of aviation fuels to the Department of Defense.
    - Taxpayers (or related persons) who are refiners of crude oil and whose daily refinery output, on any day during the taxable year, exceeds 50,000 barrels.
- The California credit may be carried over for 15 years. The federal credit is part of the general business credit and is subject to the limitations imposed by IRC section 38.

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[1] IRC sections 43(b)(2) and 45K(d)(2)(c).
[2] IRC sections 43(b)(1) and 43(b)(3).
[3] Internal Revenue Bulletin 2007-34.
[4] Revenue and Taxation Code (R&TC) sections 17052.8 and 23604.
[5] R&TC sections 17052.8(a)(3) and 23604(a)(3).

Depletion

Federal Law

IRC section 611 provides the general rules for depletion. Depletion permits a taxpayer a reasonable allowance for depletion in the case of mines, oil and gas wells, other natural deposits, and timber. A depletion deduction is allowed to a taxpayer only if a taxpayer has an economic interest in the property, if the property is exhaustible, and the costs are not based on physical property.

There are two depletion methods: (1) Cost depletion, and (2) Percentage depletion.

Cost Depletion: This method is similar to the units-of-production depreciation method in which the depreciation is related to the level of the output during each period in comparison to the total output possible during the depreciable life of the asset. Cost depletion starts by computing the basis per recoverable unit of the natural resource, and the depletion allowance for any given period is computed by multiplying the basis per recoverable unit by the number of units produced in that period.

Percentage Depletion: In percentage depletion, the gross possible income from the property is amortized over the life of the property, in contrast to the amortization of the cost that is used in depreciation and in cost depletion. Gross income from the property, therefore, needs to be computed before determining the percentage depletion. Also, because the depletion is on the basis of the income as opposed to the cost, it is possible that the total depletion can exceed the total cost of the property.

For any trade or business engaged in the production of oil:

- Only independent producers and royalty owners may claim the percentage-depletion deduction. The depletion deduction is 15% of the gross income from the property, not to exceed 100% of the taxable income from the property for the tax year.[6]
- The percentage-depletion allowance is limited to 65% of total taxable income for the year computed without regard to the depletion deduction.[7]
- The maximum depletable amount is 1,000 barrels of oil per day.

State Law

California conforms to federal law with respect to depletion for any trade or business engaged in the production of oil.[8]

Under current law, unless otherwise provided, credit carryover amounts in existence at the time a credit is repealed are allowed under the terms of the repealed law.

[6] IRC section 613A(c).
[7] IRC section 613A(d).
[8] R&TC sections 17681 and 24831.

THIS BILL

This bill would repeal the enhanced oil recovery credit and disallow percentage depletion for any trade or business engaged in the oil production business.

Because this bill does not include language that provides otherwise, existing EOR credit carry over amounts would continue to be allowed.

IMPLEMENTATION CONCERNS

The department has identified the following implementation concerns. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

This bill provides that the EOR credit would be repealed for tax years beginning on or after January 1, 2008. This bill does not address existing credit carryover amounts. Under current law,[9] a carryover amount arising under prior law survives the repeal of that law. If it is the author's intent to disallow the use of existing EOR credit carryovers in addition to eliminating the creation of future EOR credits, the author would need to specifically include language that overrides existing law.

This bill uses a term that is undefined in the Internal Revenue Code, i.e., "business of oil production" for purposes of defining taxpayers eligible for a depletion deduction. The absence of a definition to clarify this term could lead to disputes with taxpayers.

LEGISLATIVE HISTORY

ABX3 9 (Nunez, 2008) would have imposed a surtax on California net income that arises from business activities in the petroleum industry and a severance tax on oil extracted in California. ABX3 9 was held in the Assembly Revenue and Taxation Committee.

SB 1484 (Alquist, 2008) would have repealed the EOR credit and depletion deduction as of January 1, 2011. SB 1484 was held in the Senate Revenue and Taxation Committee.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota,* and *New York.* These states were selected due to their similarities to California's economy, business entity types, and tax laws.

Florida conforms to federal treatment of the depletion deduction for corporations. (*Florida* does not impose a personal income tax.)

Illinois, Massachusetts, and *Michigan* conform to the federal rules for depletion.

Minnesota and *New York* allow cost depletion, but do not allow percentage depletion.

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[9] R&TC sections 17029 and 23053

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

Based on data and assumptions discussed below, this bill would result in the following revenue:

Revenue Impact of ABX3 30 as Introduced September 5, 2008 Enactment Assumed Before January 1, 2009 ($ in Millions)			
	2008-09	2009-10	2010-11
Percentage Depletion	+$28	+$26	+$25
Enhanced Oil Recovery Credit	$0	$0	$0

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill. The numbers in the table above have been adjusted to reflect revenue estimates for fiscal years.

Revenue Discussion

Enhanced Oil Recovery Credit

Current law allows certain independent oil producers a nonrefundable credit equal to 5% of the qualified enhanced oil recovery costs for projects located in California. The credit has been phased out since 2006 due to the high price of oil. Assuming that oil prices continue to be high, this provision would not have a revenue impact.

Depletion

Under current law, independent oil producers and royalty owners are allowed a deduction equal to 15% of the gross income from the oil wells (up to 1,000 barrels of oil per day). The deduction is limited to the taxable income from the property before deducting depletion. However, percentage depletion continues to be deductible provided that there is gross income from the property even after the taxpayer's basis for the property has been reduced to zero.

Revenue estimates for the repeal of percentage depletion deduction are based on the estimates of the cost of this provision at the federal level. Federal costs are pro-rated to California costs based on the ratio of California and national oil production. The revenue estimate calculation can be shown as follows:

Change in CA revenue = “A” x “B” x Federal Revenue

Where “A” equals the ratio of the California Tax Rate to the Federal Tax Rate and
“B” equals the ratio of California Oil & Gas Revenues to Federal Oil & Gas Revenues.

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