Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author: Calderon | Analyst: Colin Stevens | Bill Number: AB 687

Related Bills: See Legislative History | Telephone: 845-3036 | Amended Date: 4/26/99

Attorney: Doug Bramhall | Sponsor: CA Independent Petroleum ASSN

SUBJECT: Percentage Depletion Deduction/Oil And Gas Wells

SUMMARY OF BILL

Under the Personal Income Tax Law (PITL) and the Bank and Corporation Tax Law (B&CTL), this bill would make the following changes for independent oil producers, as defined:

1. Increase to 20,000 from 1,000 the number of barrels of oil that may be produced daily while still permitting a taxpayer to take percentage depletion;
2. Increase the maximum allowable percentage that may be used in calculating the deduction for percentage depletion, the amount of the increase would depend upon the price of certain specified crude oil;
3. Specify that the additional percentage that may be used in calculating the deduction for percentage depletion would be allowed only to independent producers and not royalty owners;
4. Remove a depletion limitation cap of 100% of the taxpayer's taxable income from the property;
5. Remove the depletion limitation cap of 65% of the taxpayer's modified taxable income;
6. Increase from $5 million to $15 million the amount of gross receipts above which a taxpayer cannot qualify to receive percentage depletion because they are then considered a retailer of oil or natural gas;
7. Allow a 3-year carryback or a 15-year carryforward of any depletion deduction that cannot be used in the year generated;
8. Allow certain property currently ineligible for percentage depletion for periods after 1974 to be eligible for percentage depletion.

The bill as introduced February 23, 1999, has not been analyzed.

EFFECTIVE DATE

As a tax levy, this bill would apply to taxable or income years beginning on or after January 1, 1999. However, the provision relating to the depletion limitation cap of 50% specifies that it would apply for taxable years beginning after December 31, 1995.

LEGISLATIVE HISTORY

SB 38 (Stats. 1996, Ch. 954) conformed with modifications to the federal enhanced oil recovery credit (limited to independent producers only; SB 1788 (1998) would have excluded from income certain oil or gas production: failed passage; AB 1610 (1999) would allow a credit for crude oil produced from marginal wells located in this state.

Board Position:			Department Director	Date
____ S	____ NA	____ NP		
____ SA	____ O	____ NAR		
____ N	____ OUA	X PENDING	**Gerald Goldberg**	**5/4/1999**

SPECIFIC FINDINGS

Federal and state laws allow a variety of special tax credits and deductions designed to promote or influence specific taxpayer behavior believed to generate social or economic benefits for the general public. Included in state and federal law are tax incentives designed to promote extraction of resources, including the credit for enhanced oil recovery and special laws relating to the depletion of the resources.

Under federal and state laws, all exhaustible mineral deposits and timber qualify for deduction of a reasonable allowance for depletion. Two methods are provided, cost depletion and percentage depletion. **Under federal and state laws,** cost depletion is based on the property's adjusted basis, the number of recoverable units of the mineral at the beginning of the year, and the number of units sold or for which payment is received during the year. The taxpayer's total cost depletion cannot exceed his or her basis for the mineral deposit or timber. The adjusted basis for cost depletion and gain or loss is the cost basis of the property plus or minus any basis adjustments. It does not include the basis of non-mineral property, such as amounts recoverable through depreciation, or the residual value of land and improvements.

Certain extractive industries may choose to use **percentage depletion,** where deductions may be computed as a specified percentage of gross income from the property if the deductible amount exceeds the amount which would have been deductible using cost depletion. Percentage depletion is unrelated to the taxpayer's cost basis in the depletable property and, as the taxpayer's basis in the depletable property is reduced, is more advantageous than cost depletion since percentage depletion may continue to be deducted for as long as the property produces income. Taxpayers who may claim percentage depletion are limited to mining properties and certain interests in oil and gas wells. Where the property is entitled to either cost depletion or percentage depletion, the allowable deduction for any year is the greater of the two.

Under federal and state laws, a taxpayer may take a depletion deduction only if he owns an "economic interest" in the mineral deposit or timber. Owners of an economic interest generally include owner-operators, lessors and lessees, owners of a royalty interest or retained net profits, and owners of a production payment to the extent it is not treated as a mortgage loan.

Under federal and state laws, percentage depletion for oil and gas wells generally is limited to independent producers and royalty owners. Independent producers include only producers and royalty owners who do not have an interest in a refinery that produces more than 50,000 barrels of oil on any day of the year, or who do not sell more than $5 million worth of oil or gas through any retail outlet operated by the taxpayer or a related party. The maximum daily amount of production that qualifies for percentage depletion is 1,000 barrels of oil or 6 million cubic feet of gas. A taxpayer who has both crude oil and natural gas production must allocate the maximum depletable amount between oil and gas at the rate of 6,000 cubic feet of gas per barrel of oil. If a taxpayer's production exceeds the maximum limits, percentage depletion is retained for as much of the average daily production that does not exceed the amounts allowed for percentage depletion.

In general, the deduction for percentage depletion of all minerals may not exceed 50% of the taxpayer’s taxable income from the property. For oil and gas properties of independent producers, the limitation was 65% of the taxpayer's modified taxable income from all sources. However, for taxable years beginning after December 31, 1997, and before January 1, 2000, federal law suspends application of the limitation of 100% of taxable income from the property on the calculation of percentage depletion for such property, allowing taxpayers to offset income from other properties with deductions in excess of taxable income attributable to percentage depletion. California conformed to the suspension provision for taxable or income years beginning on or after January 1, 1998.

State law conforms, with certain significant modifications, to the federal NOL provisions. Generally, an NOL results when a taxpayer's business expenses exceed income in a particular year, thereby resulting in an "operating loss" for that year which is carried forward (or back) as a "net operating loss." For **federal** purposes, an NOL can be carried back to each of the two preceding years and carried forward to each of the 20 following years. **California** modifies the federal NOL rules to prohibit carry-back of the NOL deduction and to specify that generally only 50% of the NOL can be carried forward as a deduction for a period of five years (certain special rules apply in the case of an "eligible small business" or a "new business").

Federal and state laws allow taxpayers an enhanced oil recovery (EOR) credit. The federal credit is 15% of the taxpayer’s qualified EOR costs, which are defined as amounts paid or incurred for qualifying tangible property which is depreciable or amortizable and an integral part of a qualified EOR project, qualifying tertiary injectant costs, and qualifying intangible drilling and development costs. The credit is allowed on costs connected to a qualified EOR project that involves the application of a tertiary recovery method, which is expected to result in a significant increase in the amount of crude oil recovered.

The **state** EOR credit is equal to one-third of the federal credit. The federal EOR credit rules apply with specific modifications. Included in the modifications is the limitation that allows the state credit only for independent producers.

Federal and state laws generally provide that an independent producer or royalty owner may not claim percentage depletion for interests in “proven” oil or gas property transferred after December 31, 1974, and before October 11, 1990. Certain exceptions to this rule apply. This limitation was removed for properties transferred after October 11, 1990, but has not been removed for properties transferred prior to that date but after December 31, 1974.

Existing state law provides for alternative minimum tax (AMT) to ensure that no taxpayers with substantial economic income avoid all tax liability by using exclusions, deductions, and credits (tax preference items). The corporate rate is rate of 6.64% for income years beginning on or after January 1, 1997, while the PITL rate is 7% for taxable years beginning on or after January 1, 1996.

Under the PITL and the B&CTL, **this bill** would:

- Increase to 20,000 from 1,000 the number of barrels of oil that could be produced daily while still allowing a taxpayer to qualify for percentage depletion;
- For independent oil producers only, increase the maximum allowable percentage that may be used in calculating the amount of percentage depletion, the additional amount of which would depend upon the price of 13 degree Kern River crude oil;
- Remove a depletion limitation cap of 100% of the taxpayer's taxable income from the property for independent producers and royalty owners;
- Remove the depletion limitation cap of 65% of the taxpayer's modified taxable income for independent producers and royalty owners;
- Increase from $5 million to $15 million the gross receipts limit above which a taxpayer cannot qualify to use percentage depletion;
- Provide that sales of oil or gas or any product made from oil or gas outside of California would not be included for purposes of the $15 million limitation;
- Allow certain property that was ineligible for using percentage depletion for periods after 1974 to utilize percentage depletion.

The additional percentage allowed would depend on the Kern River posting price for crude oil with a gravity of 13 degrees. The percentages would be as follows:

Average Kern River Posting Price	Additional Percentage
$11.99/bbl. - $10.00/bbl.	10.00
9.99/bbl. - 8.00/bbl.	20.00
7.99/bbl. or below	30.00

The average Kern River posting price would be computed by using the average of the aggregate posting prices of each of four specified California refineries, with a specified replacement mechanism in the case where any of the four specified producers cease posting such prices.

Any allowed deduction that is not used in the year generated could be carried back for up to three years and carried forward for 15 years.

Policy Considerations

This bill would create an additional difference between federal and state laws, requiring that another adjustment be made and an extra set of records be kept by taxpayers and increasing the complexity of preparing a California franchise or income tax return.

Since this bill, through the carryback mechanism, would allow reduction of previously-vested tax liabilities for years 1996, 1997 and 1998, years in which tax benefits will have already vested by the time this bill can be enacted, it may be considered a gift of public funds and may be held to be unconstitutional without the addition of public purpose language.

This bill would allow a taxpayer to carry back for three years or forward for 15 years unused deductions generated as a result of this bill's provisions. For producers operating marginal wells, this bill may result in a benefit since the taxpayer may otherwise receive an NOL deduction and an immediate 50% reduction thereto.

However, for taxpayers without marginal wells who can carry over without limitation any deductions attributable to percentage depletion, this bill would limit their carryover to 15 years.

Although federal law allows a carry back of certain deductions in certain cases, such as net operating and casualty losses, state law, with the exception of the election to claim certain disaster losses in the year preceding the loss, does not allow carrybacks of any of these items. This bill would allow a taxpayer to carry back a deduction for up to three years, which is unprecedented under state law. This bill also would retroactively repeal the limitation on percentage depletion for certain properties transferred between 1974 and 1990, as well as retroactively allow taxpayers to offset deductions greater than 100% of income from oil and gas properties against income from other properties.

Implementation Considerations

Department staff is working with the author's office to resolve the considerations identified below.

Standard carryover language for credits specifies that a credit amount that exceeds the amount of net tax would be carried forward to future years. This bill specifies that a deduction attributable to this bill could be carried back three years or forward for 15 years, but does not describe whether the period would begin in the year in which the deduction is claimed. In addition, it is not clear what amount is actually subject to the carryback and carry forward treatment. The author's staff has indicated that the intent was that only the amount of the percentage depletion deduction computed under the rules in this bill that is in excess of any deduction allowed for cost depletion would be eligible to be carried back or forward. Additional language would be required to accomplish the author's intent.

This bill specifies that the $12 price of Kern River 13 degree crude be adjusted each year for inflation. However, many price indexes are available and to avoid disputes, the index must be defined. It would assist the department if the $12 price is indexed to the California Consumer Price Index in a manner similar to other items in the Revenue and Taxation Code. In addition, it would be helpful if the baseline date from which inflation adjustments are to be computed was clearly specified in the bill.

The author's office has indicated that this bill is intended to apply only to those portions of a taxpayer's operations located inside California. This bill will require additional language to effectuate the author's expressed intent.

It is unclear where department staff would get the information to verify the average Kern River posting price for the California refineries. According to staff from the Department of Conservation Division of Oil and Gas, the posting price for each refinery is available, but no single source posts the aggregate of the daily prices posted for the four refineries. Compiling the information in order to verify the average posting price for all four refineries, potentially on a daily basis, could require significant expenditure of department staff resources.

A specified formula to compute the average daily posting price and the aggregating of the daily prices to determine the average posting price for a calendar year would assist the department in implementation of this bill and help ensure disputes do not arise between taxpayers and the department.

The author's office has indicated that deductions for percentage depletion under this bill are intended to be allowed to reduce regular tax below the tentative minimum tax.

Percentage depletion deductions are not currently part of the alternative minimum taxable income calculations. However, certain aspects of an oil or gas producer's operations, such as intangible drilling costs, often do produce AMT interactions. Additional language to alter the general AMT provisions would be required to allow the additional deductions for percentage depletion generated under this bill to reduce the total amount of tax paid by independent oil producers.

Federal law defines a "domestic producer." However, this bill does not define a "domestic producer." Since a domestic producer could be either a producer in California or one in the United States, additional clarification as to the author's intent could help to ensure that disputes do not arise between taxpayers and department staff.

The provision relating to the depletion limitation cap of 50% specifies that it would apply for taxable years beginning after December 31, 1995, creating the potential for amended returns and an additional minor workload.

Technical Considerations

The author's office has indicated that subdivision (b) of Sections 17683 and 24833 is intended to allow a taxpayer whose average daily production exceeds the increased daily per barrel amount allowed by this bill to allocate that production to fields that would most benefit from the additional percentage depletion. The language would need additional clarification to accomplish this intent.

This bill would twice provide that certain property that was ineligible for using percentage depletion for periods after 1974 could utilize percentage depletion in the calculation of deductions. It is unclear why the provision needs to be identified twice in the bill. Further, the language in this bill that would allow percentage depletion for properties ineligible after 1974 specifies that it would apply to a "transfer" while the repealed federal language specifies that it applies to a "transferee."

The B&CTL provisions use the term "taxable year" in several places. The B&CTL provisions should refer instead to "income year."

The language for additional deductions may be confusing since it could be read that the qualified taxpayers would receive a deduction of 10% if the price of oil is between $11.99 and $10 per barrel, 20% if the price is between $9.99 and $8.00, etc, instead of an increased amount over the basic 15% specified in Section 613A(c)(1) of the Internal Revenue Code. However, the author's office has indicated the intent that the percentages specified in the bill would be 25%, 35% and 45%. The bill would be clearer if language substituting total percentage amounts (including the basic 15% amount plus the enhanced amount, if any) were inserted rather than the existing language.

This bill refers to the "posting price" of crude oil. The terminology usually used by the industry is "posted price."

FISCAL IMPACT

Departmental Costs

Once the implementation considerations are resolved, this bill is not expected to significantly impact the department's cost of operations.

Tax Revenue Estimate

The estimated revenue impact of this bill is shown in the following table:

Revenue Losses of AB 687 As Amended April 16, 1999 Effective for Tax Years Beginning on and After January 1, 1999 Assumed enactment after June 30, 1999 $ Millions		
1999-00	2000-01	2001-02
-$4	-$5	-$5

This analysis does not take into account any change in employment, personal income, or gross state product that may result from this bill becoming law.

Tax Revenue Discussion

The revenue impact of this bill would be determined by the additional amounts of depletion deductions by independent oil and gas companies as a result of increasing the barrel production limitation and the percentage depletion cap, as well as the elimination of the taxable income limitation. This analysis used the data provided by the industry, micro-level taxpayer data, and publicly available financial information. This estimate was calculated in the following steps. The Kern River Posting price was assumed to be $8.00/barrel, based on the Kern River crude prices for 1998, which averaged about $8 per barrel during 1998. The high price was approximately $11 with a low of about $6.50 per barrel. So far in 1999 Kern River crude prices have fluctuated from a low of about $6.50 to a high of just under $12. On the basis of this, the additional percentage for percentage depletion deductions was determined. Based on the industry-provided data on the number of barrels, the amount of the increase in deductions was calculated. Based on conversations with the author's office, it was also assumed that taxpayers could not carry back or forward deductions attributable to cost depletion and could carry back or forward only those amounts attributable to percentage depletion that are in excess of what is allowed under cost depletion. Moreover, based on conversations with the author's office, it was assumed that percentage depletion deductions could reduce AMT. If the deductions attributable to cost depletion were also allowed to be carried back or forward, the tax effect would be greater.

BOARD POSITION

Pending.