

CONGRESS SHOULD PRESERVE THE WORKING INTEREST RULE

President Obama's budget submission to Congress for FY 2011 includes a package of proposals to raise taxes on the oil and natural gas industry. Included in the package is a proposal to repeal the working interest rule of section 469 of the tax code.

Congress should reject the proposal to repeal the working interest rule because the rule is sound tax policy; the rule permits individuals who invest in oil and gas properties to deduct losses resulting from the development of the properties if the individual is personally liable for those costs. The repeal of the rule will senselessly force a shift of oil and gas investments away from individuals to corporations since corporations would not be affected by the repeal. The alternative minimum tax already applies to limit the deductibility of drilling costs.

Additionally, the repeal of the working interest rule will discourage drilling at a time when technological advances and new discoveries have given the country 100 years of reserves of natural gas – reserves that, if developed, could meaningfully increase the country's energy independence. The Treasury Department estimates that the repeal of the rule would raise virtually no new revenue.

Background

The Passive Loss Rules. In the Tax Reform Act of 1986, Congress enacted rules to curtail the deductibility of business losses by individual taxpayers. Those rules – termed the passive loss rules – generally preclude individuals from deducting losses from businesses in which the taxpayer does not materially participate. Disallowed losses become deductible when the taxpayer realizes net income from the business or disposes of the interest in the business. The rules do not apply to corporations.¹

The Working Interest Rule. For investments in oil and natural gas businesses, Congress provided taxpayers with an alternative to material participation. Congress permitted taxpayers to deduct losses from oil and natural gas investments if the investments are made in the form of a working interest – i.e., an interest that carries with it the obligation to share in the costs to develop the resources on the property. To qualify, the taxpayer must hold the working interest through an entity that does not limit his or her liability with respect to the interest. Thus, a taxpayer who holds a working interest in the prescribed fashion and puts up capital to fund the drilling of oil and natural gas wells is entitled to deduct his or her share of tax losses resulting from the drilling expenditures, which are known as intangible drilling costs (IDCs).

¹ Except for closely held or personal service corporations (i.e., corporations that are effectively the alter ego of individuals).

The deductibility of IDCs. Since 1913, the tax code has permitted taxpayers to expense IDCs. It is the deduction for IDCs that typically creates the loss that the investor can deduct if the investors holds a working interest as described above.

Working Interest Rule is Sound Tax Policy

Working interests are not like the arrangements targeted by the passive loss rules. The working interest rule reflects the recognition by Congress in 1986 that investments in working interests in oil and natural gas are very different from the types of investments that led to the passive loss rules. Specifically, it was common in the early 1980s for taxpayers to invest in arrangements that (i) depended on the use of nonrecourse debt and depreciation deductions to generate tax losses, (ii) were motivated primarily by tax benefits rather than bona fide economic objectives, or (iii) were devoid of economic substance entirely and instead were designed simply to generate substantial tax losses. It was not uncommon in some cases for investors to deduct losses equal to many multiples of the amount of capital they had invested and the amount of debt for which they were personally liable.

In stark contrast, 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.

Rather than have oil and natural gas working interests swept up in a set of reforms that had a very different focus, in 1986 Congress sensibly decided to provide investors in working interests an alternative to material participation. Congress's conclusion was effectively that an investment in a working interest should automatically be considered material participation in the business.

Deductions For Drilling Costs Are Restricted By The Alternative Minimum Tax. For AMT purposes, taxpayers must amortize the cost of drilling successful oil and natural gas wells over 10 years unless the taxpayer has oil and natural gas income against which to deduct those costs (and even in that case only a portion of the costs are deductible). The AMT effectively limits a taxpayer's deduction for drilling costs and ensures that taxpayers pay income tax each year. For investments in working interests, the application of the passive loss rules, with the material participation requirement included, would be unnecessary and excessive; thus, the enactment of the working interest rule as an alternative to material participation was a sensible outcome.

Working Interests Represent Traditional Method of Raising Capital for Drilling; Repeal of the Working Interest Rule would shift investments to corporations. For many decades, oil and natural gas operators have sought individual investors to contribute capital and share the risk of drilling wells. Most wells in the United States 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 this system. Because Congress exempted corporations from the passive loss rules, the repeal of the working interest rule will

senselessly drive oil and natural gas investments away from individuals and toward corporations. Given the applicability of the AMT to drilling costs of individuals, there is no apparent reason why Congress would or should favor corporate over individual ownership of working interests.

Deduction for Drilling Costs is Consistent with Other Tax Deductions. The deduction for drilling costs, which can result in the realization of losses by the investor in a working interest, is consistent with the tax treatment of many other expenses that have the potential to create value for the future. For example, research costs can generate valuable patents and technology, but those costs are eligible both for a current deduction and an additional tax credit. Many other business expenditures, such as advertising, generate future enterprise value, but, again, are fully deductible. There is no basis for Congress to eliminate or restrict the deduction for drilling costs, especially given that the deduction is subject to the AMT (and research costs are not). Nor is that deduction a reason for Congress to eliminate or restrict the working interest rule.

Repeal Of The Working Interest Rule
Would Discourage Drilling and Raise Little Revenue

Repeal of the Working Interest Rule would Discourage Development of the Huge U.S. Natural Gas Reserves. U.S. reserves of natural gas were once thought to be dwindling. But the reserves now are larger ever because of technological developments and recent discoveries; the country has nearly a *100-year supply*, at current consumption levels, according to recent reports. Given the size of the resource, it would make little sense for the government to take steps to discourage drilling at this time; expanded drilling for natural gas has the potential to help secure the country's energy independence. The repeal of the working interest rule will dampen drilling activity by interfering with the traditional sources of capital for many small and independent oil and natural gas companies. In many cases, those companies would have to find replacement sources of capital from corporations since corporations are exempt from the passive loss rules.

Repeal of the Working Interest Rule Would Raise Insignificant Revenue for the Government. The Treasury Department estimates that the repeal of the working interest rule would generate on average than \$20 million in new revenue a year over the next decade. That number does not approach the size of even a rounding error in the federal budget. The repeal of the working interest rule is mainly just a matter of the timing of deductions. In most cases, losses disallowed by the repeal of the rule would be deductible soon thereafter – either when the well is determined to be unsuccessful or as the well generates income against which to take the deduction. Additionally, as described previously, the repeal of the rule will cause a shift of oil and gas investment from individuals to corporations; corporations would not be affected by the repeal. It would make little sense for Congress to take an action that would interfere with the traditional sources of capital for oil and natural gas companies, given the minimal revenue effect.

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