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Mineral Law Program

A. L. Sage

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A. L. Sage, III

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The Mississippi Mineral Resources Institute
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FINAL TECHNICAL REPORT

MINERAL LAW PROGRAM

MISSISSIPPI LAW RESEARCH INSTITUTE

LAW CENTER

UNIVERSITY OF MISSISSIPPI

A.L. SAGE, III

PRINCIPAL INVESTIGATOR

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Final Technical Report

Attached hereto are the results of the research and publications for MMRI Project 88-9F, the Mineral Law Program conducted under the auspices of the Mississippi Law Research Institute of the Law Center, University of Mississippi. Principal Investigator of the Mineral Law Program is A.L. Sage, III. The Mississippi Mineral Resources Institute provides funding for student researchers, travel and commodities.

The past year saw the publication of one issue of the Mineral Law Update, drafting of a second issue and the completion of research for a third issue. The third issue is currently being drafted. The completed issue is attached.

The principal investigator participated in the formation of the Natural Resources Section of the Mississippi State Bar, and was named chairman of the publications committee. The scope of the section is broader than that of either the Mississippi Oil and Gas Lawyers Association or the Mississippi Association of Petroleum Landmen. The Mineral Law Update will serve as the quasi-official publication of the Natural Resources Section, and its scope will be expanded. The expertise of the members of the Section will greatly add to the expertise available to the principal investigator.

The principal investigator also helped organize a meeting between various members of the oil and gas bar and the Oil, Gas and Other Minerals Committee of the Mississippi House of Representatives. Various members of the Senate committee also attended the meeting.

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THE TAX REFORM ACT OF 1986 AS IT AFFECTS THE OIL AND GAS INDUSTRY

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There is a pervasive misconception that the oil and gas industry has been singled out and left immune to the sweeping "reform" provisions of the Tax Reform Act of 1986 (the "Act"). The fact is, however, that as a result of the Act, the oil and gas industry will bear a significant portion of the tax burden being shifted to corporate taxpayers. It has been estimated that the oil and gas industry-specific provisions alone will cause the industry to pay, at a minimum, $879 million more federal income tax over the next five years. In addition, the industry is expected to pay more than $10 billion[1] additional federal income taxes over the next five years as a cumulative result of the provisions of the Act.

The administration and the legislators did recognize both the current plight and the national significance of the oil and gas industry. Consequently, the Act did not repeal certain critical tax laws permitting current deductions for intangible drilling costs and percentage depletion. However, as shown below, investment in the oil and gas industry will be less attractive in the future than under current law and, certainly, that will have an immediate detrimental effect on the domestic oil and gas industry.

This article specifically discusses the following areas of the Act which will impact the oil and gas industry:

- Oil and Gas Business Provisions
- Oil and Gas Investment Provisions
- Alternative Minimum Taxes

Oil And Gas Business Provisions

Intangible Drilling Costs

Because of the critical nature of the domestic oil and gas industry with respect to our national security and, most likely, because of the recent tremendous decline in domestic drilling, the Act did not include any changes related to the current deductibility of IDC's on domestic well incurred by independent producers. However, current deductions for IDC's of integrated producers and on foreign wells of all producers have been affected.

The Act provides that *integrated producers* must capitalize 30% of IDC's paid or incurred after December 31, 1986. The capitalized amount will be amortized on a straight-line basis over a 60-month period beginning in the month that the cost is paid or incurred. This compares with the existing law which provides that integrated producers must capitalize 20% of IDC's with a subsequent 36-month amortization. The deduction for IDC's incurred on dry holes is not affected by the new law.

The Act also provided that IDC's incurred outside the United States should be deducted, at the option of the taxpayer, over either 1) a 10-year period on a ratable basis or 2) the life of the property using the property's annual cost depletion rate. Note that the statutory language provides that this election is to be made by the taxpayer, whereas the language of the Conference Report provides that the election is to be made by the property operator. Although it is not clear, it seems more likely that Congress intended that each taxpayer would make his or her own election, since the decision will directly affect that taxpayer. At this time, it is also not clear if the election is to be made on an annual basis, a property by property basis, or a dollar basis. Presumably, the regulations will clarify that issue. Once more, deductions for IDC's incurred on dry holes are not affected by this new provision. The new law will be applied to the foreign IDC's paid or incurred after December 31, 1986 with one exception. The exception is that the new law will not apply to IDC's incurred by U.S. companies with respect to a minority interest in a license for Netherlands or U.K. North Sea development if that interest was acquired on or before December 31,1985.

Percentage Depletion

Percentage depletion deductions will no longer be available with respect to lease bonuses, advance royalties, or any other payments made without regard to actual production from an oil, gas or geothermal property. This provision applies to any amounts received or accrued after August 16, 1986.

Depreciation

Under the new law, lease and well equipment will be depreciated over a longer period than under the existing ACRS method. Lease and well equipment placed in service after December 31, 1986 will be depreciated over a seven-year life under a double declining balance method of depreciation. Alternatively, for a less accelerated approach, that equipment could be depreciated under a straight-line method (over seven years) or a unit of production method (over the life of the property). It is important to note that equipment placed in service prior to 1987 can and will continue to be depreciated under the methods available under current law. However, an election to use the new provisions for equipment placed in service after July 31, 1986 is available.

Investment Tax Credit

The investment tax credit (ITC) is generally repealed for qualifying property placed in service after December 31, 1985. However, certain transition property may still qualify if it was subject to a binding contract or under