Potential Availability for 2016

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AMONG THE FEDERAL TAX benefits potentially available to oil and gas producers are the Enhanced Oil Recovery Credit and the Marginal Well Production Credit. Each of these credits is subject to reduction (or complete elimination) based upon national average oil and natural gas prices, as determined by the Internal Revenue Service.

As a result, the Enhanced Oil Recovery Credit has been entirely unavailable for the 10 years prior to 2016, and the Marginal Well Production Credit has been entirely unavailable since its enactment in 2004. However, for 2016, the Enhanced Oil Recovery Credit is once again available (without reduction).

In addition, while the Marginal Well Production Credit remains entirely phased out for 2016 with respect to *oil* production, as of the date of this article's release for publication, it is unclear whether or not the Marginal Well Production Credit will be available in 2016 for *natural gas* production. (The reason for this uncertainty is discussed below.)

It is hoped that the Internal Revenue Service will release additional guidance on this question soon. (The OOGA Tax Committee will continue to monitor this issue, and will provide further information to OOGA members as it becomes available.) The following describes the computation and requirements of each of the Enhanced Oil Recovery Credit and the Marginal Well Production Credit. Producers who believe that they might be eligible for the Enhanced Oil Recovery Credit or the Marginal Well Production Credit for 2016 are encouraged to discuss this with their tax advisors.

CODE[1] SECTION 43: ENHANCED OIL RECOVERY CREDIT RULES

Enhanced Oil Recovery Credits are generally available for "qualified enhanced oil recovery projects."[2] The credit may be claimed by holders of operating interests in an aggregate amount equal to 15 percent of the "qualified enhanced oil recovery costs" of the project for a particular year.[3] Each of these terms is described further below.

Qualified Enhanced Oil Recovery Project

A "qualified enhanced oil recovery project" is generally a project located in the United States that involves the application of one or more "qualified tertiary recovery methods" that can reasonably be expected to result in more than an insignificant increase in the amount of crude oil that ultimately will be recovered. "Qualified tertiary recovery methods" is defined under applicable Treasury regulations to include steam drive injection, cyclic steam injection, in situ combustion, miscible fluid displacement, carbon dioxide augmented waterflooding, immiscible carbon dioxide displacement, immiscible nonhydrocarbon gas displacement, microemulsion flooding, caustic flooding and polymer augmented waterflooding.[4] (Taxpayers may also request a private letter ruling from the Internal Revenue Service for approval of a method not included in this list.) Qualified tertiary recovery methods specifically *do not* include waterflooding, cyclic gas injection, horizontal drilling or gravity drainage.[5]

In addition, generally only projects with respect to which the first injection of liquids, gases, or other matter commenced after Dec. 31, 1990 are eligible for Enhanced Oil Recovery Credits.[6] Treasury regulations provide an exception to this limitation for projects that undergo a significant expansion after Dec. 13, 1990 and meet certain requirements.[7]

Finally, in order for a project to qualify as a "qualified enhanced oil recovery project," a certification from a petroleum engineer for the first taxable year for which the Enhanced Oil Recovery Credit is allowable must be submitted to the Internal Revenue Service. This certification must contain (1) a statement that the project involves a qualified tertiary recovery method and a description of the process used, (2) a statement that the application of a qualified tertiary recovery method or methods is expected to result in more than an insignificant increase in the amount of crude oil that ultimately will be recovered, and (3) a statement that the petroleum engineer believes that the project qualifies as a "qualified enhanced oil recovery project." For each later taxable year, the operator or designated owner must certify that the project continues to be implemented substantially in accordance with the petroleum engineer's certification.[8]

Qualified Enhanced Oil Recovery Costs

"Qualified enhanced oil recovery costs" include (1) amounts paid or incurred for depreciable or amortizable tangible property that is an integral part of the qualified enhanced oil recovery project, (2) deductible intangible drilling and development costs paid or incurred in connection with the qualified enhanced oil recovery project, and (3) deductible costs paid or incurred for any tertiary injectant (other than a hydrocarbon injectant that is recoverable) that is used as a part of a tertiary recovery method.[9]

Phase out of Enhanced Oil Recovery Credit

The amount of the Enhanced Oil Recovery Credit for any taxable year may be reduced based on the applicable "reference price" for crude oil. The Internal Revenue Service determines the reference price, which is the estimated annual average wellhead price per barrel for all domestic crude oil the price of which is not subject to regulation by the U.S. If the reference price for the *prior* year exceeds a statutory threshold (adjusted for inflation), the amount of the credit is reduced, and if that reference price exceeds the statutory threshold by $6 or more, the credit is phased out completely. The Internal Revenue Service publishes the reference price and statutory threshold annually.

For purposes of computing the credit for taxable years beginning in 2016, the published reference price is $44.39 and the statutory threshold is $46.10, so that the credit is not limited for 2016. Whether the credit will be reduced, or eliminated, for 2017 will depend upon the 2016 crude oil reference price.

AMT Limitation

The Enhanced Oil Recovery Credit is not allowable for a taxpayer that is subject to the alternative minimum tax.[10]

Additional Rules

Any deduction or capitalized amount that otherwise would be allowable for an expenditure that is taken into account in computing the amount of the Enhanced Oil Recovery Credit must be reduced by the amount of the credit attributable to the expenditure. In addition, certain other generally applicable limitations may apply to the credit.

A taxpayer may elect not to take the Enhanced Oil Recovery Credit, or may revoke such an election, for any taxable year.

CODE SECTION 45I: MARGINAL WELL PRODUCTION CREDIT RULES

The Marginal Well Production Credit available for natural gas production in a taxable year is equal to the product of 50 cents per 1,000 cubic feet of "qualified natural gas production" attributable to the taxpayer.[11]

Qualified Natural Gas Production

"Qualified natural gas production" generally is natural gas produced from a "qualified marginal well." However, production is not treated as qualified natural gas production to the extent production from a well during the taxable year exceeds 1,095 barrel-of-oil equivalents. (This limitation is reduced proportionately for wells not in production for an entire taxable year.)

Qualified Marginal Wells

A "qualified marginal well" is a domestic well which, during the taxable year (1) has average daily production of not more than 25 barrel-of-oil equivalents and produces water at a rate not less than 95 percent of total well effluent, or (2) has "marginal production." For this purpose, "marginal production" is generally natural gas produced during the taxable year from a property that is a "stripper well property" for the year (that is, property for which the amount determined by dividing the average daily production of natural gas from producing wells on the property by the number of producing wells is 15 barrel-of-oil equivalents or less).

Phase Out of Marginal Well Production Credits

The Marginal Well Production Credit for natural gas may be reduced (or eliminated) in any year based upon the applicable natural gas reference price for such year. The reference price for qualified natural gas production for a particular year is the Internal Revenue Service's estimate of the annual average wellhead price per 1,000 cubic feet for all domestic natural gas for such year. If the reference price for the *prior* year exceeds a statutory threshold (adjusted for inflation), the amount of the credit is reduced, and if that reference price exceeds the statutory threshold by 33 cents or more, the credit is phased out completely.

The Internal Revenue Service has not published a 2015 reference price for natural gas, and in fact has never published a natural gas reference price. In addition, there is some uncertainty as to the appropriate statutory threshold to use for this purpose. For years prior to 2015, it has seemed reasonably certain that the reference price, if published, would have been sufficiently high to result in a complete phase out of the Marginal Well Production Credit for natural gas. It is not

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clear, however, that the 2015 reference price would have the same result. The OOGA Tax Committee has been in communication with the Internal Revenue Service regarding this issue, and based upon these communications is optimistic that the Internal Revenue Service will provide guidance on the availability of the Marginal Well Production Credit for 2016 with respect to natural gas. At this point, however, it is unclear whether such guidance will be published and, if it is, whether it will result in a reduction (or complete elimination) of the Marginal Well Production Credit for natural gas for 2016. The OOGA Tax Committee will continue to monitor this issue and to report any developments to OOGA members.

AMT Limitation

The Marginal Well Production Credit is not allowable for a taxpayer that is subject to the alternative minimum tax.[12]

Additional Rules

The Marginal Well Production Credit can be carried back for up to five years (rather than the carryback period of one year generally applicable to business credits).[13] The credit is not allowable with respect to production from a qualified marginal well that is also eligible for the nonconventional source production credit (Code section 45K) for the year, unless the taxpayer elects not to claim the nonconventional source production credit for the well. In addition, certain other generally applicable limitations may apply to the credits. ■

FOOTNOTES

1. References to the "Code" in this article are to the Internal Revenue Code of 1986, as amended.
2. Code section 43(c).
3. Code section 43(a).
4. Treasury regulation section 1.43-2(e)(2).
5. Treasury regulation section 1.43-2(e)(3). In addition, special rules apply to permit credits for certain natural gas treatment plants located in the northern U.S. for the preparation of Alaska natural gas for transportation. This article does not discuss those rules.
6. Code section 43(c)(2).
7. Treasury regulation section 1.43-2(d).
8. Treasury regulation section 1.43-3.
9. Code section 43(c)(1); Code section 193(b).
10. Code section 38(c).
11. Code section 45I(a). Although the Marginal Well Production Credit is potentially available for crude oil production, no such credit is available for 2016 because the applicable reference price is too high. This article therefore only addresses the application of the Marginal Well Production Credit to natural gas production.
12. Code section 38(c).
13. Code section 39(a)(3).