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NATURAL RESOURCES RECORD

OIL AND GAS TAXATION: BRACING FOR CHANGE IN 2011

By Alma Bates, Clark Sackschewsky and Tim Buford

Oil and gas companies are currently caught in the middle of a heated corporate tax debate, and while the final legislation is still up for discussion as of this writing [late January], one thing is clear: taxes for oil and gas companies are going nowhere but up. The legislative environment has financial executives in the industry worried – 54% of CFOs surveyed in the *2011 BDO Energy Outlook* survey cited "legislative changes" as the top factor inhibiting industry growth. In his State of the Union address on January 25th, President Obama called for Congress to eliminate tax incentives for oil companies, and recently proposed legislation is on track to become law within the next year. Four specific tax provisions topped the target list for 2010, and it is expected that 2011 will bring most, if not all, of these to fruition.

▸INTANGIBLE DRILLING COSTS (IDC)

The costs associated with preparing a site for the production of oil and gas are ordinarily capital expenditures and recovered through depreciation or depletion. However, IRC §263(c) provides taxpayers with an election to deduct intangible drilling costs in the year they are incurred. If the taxpayer is an integrated oil company, IRC §291(b) states the deduction is limited to 70% of the costs incurred with the remaining 30% amortized over 60 months.

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BDO'S NATURAL RESOURCES INDUSTRY PRACTICE

BDO's Natural Resources industry practice provides assurance, tax and advisory services to emerging and established businesses in the United States and all over the world who are involved in both the traditional and alternative energy industries. Our clients often operate across borders either raising capital or making acquisitions abroad. Our extensive industry knowledge is supported by our international network of 1,082 offices in 119 countries, allowing us to provide a consistently high level of service wherever our clients do business.

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IPOS ON THE RISE

The energy/natural resources space is positioned well ahead of other industries for an uptick in IPO activity, according to the *2011 BDO IPO Outlook Survey*. The study found that 83% of capital markets executives surveyed expect to see an increase in energy/natural resources IPOs in 2011. This is surpassed only by the technology industry where 87% of capital markets executives expect an increase.

This uptick in IPO activity is due to several factors including private equity exits, anticipated increases in the price of natural resources, and growing confidence in the U.S. and global economies overall. Private equity portfolios will be the greatest source of IPOs in 2011 (47%), followed by spinoffs and divestitures (22%), venture capital portfolios (17%) and owner-managed, privately held businesses (13%).

According to Charles Dewhurst, partner and national leader of the Natural Resources practice at BDO, private equity firms are feeling more pressure to deliver returns to clients. However, a major driver for IPO activity is the anticipation that natural resources prices will trend higher as demand continues to rise. As pricing for oil, as well as precious metals, such as gold, silver and platinum, continue to increase, the appeal for companies to go public in this space will also increase.

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OIL AND GAS TAXATION

Proposed 2010 legislation in the House and Senate would have eliminated the election for applicable large taxpayers with gross revenues in excess of $100 million resulting in capitalization of IDC costs which would then be recovered through depletion.

PERCENTAGE DEPLETION

Under IRC§ 613 and 613A, a company is allowed to deduct the greater of either cost or percentage depletion to recover its capital investment in an oil or gas well. Cost depletion allocates the depletable basis of its actual capital investment to the units of minerals sold during the tax year. Percentage depletion is calculated based on a fixed percentage of 15% of gross income from the sale of oil or gas and is subject to certain taxable income limitations. Percentage depletion is often more beneficial than cost depletion as it could potentially allow the taxpayer to claim deductions greater than the capital amount actually spent to acquire the property.

Proposals during 2010 would repeal percentage depletion in the case of applicable large taxpayers with gross revenues in excess of $50 million to $100 million (depending on the proposal) requiring the use of the cost recovery method to recover their investment.

GEOLOGICAL AND GEOPHYSICAL EXPENDITURES

Companies not considered major integrated oil companies are allowed to amortize geological and geophysical expenditures according to IRC §167(h) over 24 months. However, major integrated oil companies with average daily worldwide production of crude oil of at least 500,000 barrels for the taxable year and gross receipts in excess of $1 billion must amortize these expenditures over seven years.

Proposed 2010 legislation would either eliminate IRC Section 167(h) or expand the scope of covered companies that would be required to use a seven-year amortization period for geological and geophysical expenditures to include any oil company that has gross receipts in excess of $50 million for the taxable year.

DOMESTIC MANUFACTURING DEDUCTION

Companies are allowed to take an IRC §199 deduction for qualified domestic production activities against the income from those activities. Beginning in 2010, the deduction is 9% of qualified production activity income. Revised IRC Section 199 limited the deduction for oil and gas companies to 6%.

In 2010, several proposals would have eliminated the domestic manufacturing deduction entirely, for oil and gas companies.

WHAT'S NEXT?

It is anticipated that the oil and gas industry will face similar proposals in the President's 2012 budget and therefore from the House and Senate in 2011. It is important for oil and gas companies to be aware of these possible changes, and consult their tax advisor to ensure that they are prepared for the potential impact on their profitability in the coming years.

For more information on tax provisions impacting oil and gas companies, please contact Tim Buford at tbuford@bdo.com.

BDO SPOTLIGHT:

Q&A with Kevin Hubbard, Partner and Natural Resources Industry Practice Leader

What led you to focus your accounting work in the natural resources industry, specifically?

The Sarbanes-Oxley Act of 2002 is what really drove me into the industry. At the time, we only had a few partners in Houston dedicated to working exclusively with natural resources companies. Sarb-Ox drove more questions and business than they could handle on their own. I had been working at BDO for a number of years, but dealing primarily with capital markets. I was pulled into several energy projects because of my relevant technical experience, and cut my teeth working with a variety of smaller companies. I also had great mentors internally at BDO who really knew the business inside and out and gave me invaluable training. Over time, I've become fully entrenched in all facets of the industry. It really surrounds me now, as it's such an integral part of the community at large in Houston.

What experiences have been most influential in shaping your career?

It hasn't been the experiences as much as the people. I've had opportunities to work on very interesting projects and clients that challenged and pushed me. One of the earliest projects I worked on in the energy industry probably had the biggest impact on my career. In 2006, I worked on a team that helped to take Legacy Reserves public, which was an extremely complex process. Our success there gave us very powerful credentials. We formed a strong relationship with Legacy, which led to referrals and opened a number of doors that grew our practice.

What have been the biggest challenges facing the industry recently?

The global economic downturn created the biggest challenge for energy companies in recent years. Banks pulled their purse strings tight, oil and gas prices dropped and everyone went into crisis mode. Now, it's all gravy again – at least when it comes to capital markets and commodity pricing. Legislative and regulatory issues in the U.S. are the major headache now. {As of this writing in January}, no one really knows where things will go – will there be more government oversight at a national level? A local level? Will increased regulation move onshore in the U.S. as well?

Where do you see the biggest growth opportunities in the industry?

Nonconventional resource plays will be a major driver of growth for the industry. Everyone is jumping in the game – from the major oil and gas players to smaller companies acquiring attractive acreage.

What lies ahead for the BDO Natural Resources industry practice?

More companies are gaining interest in international opportunities, and I think we'll see more of a shift happen in coming years. There are two noteworthy developing international trends. The first involves shale plays. While the development of shale plays has thus far occurred exclusively in the U.S., there are many other shale formations around the world and the U.S. energy industry is poised to export the fracking and horizontal drilling technology that it has developed into these areas. The second stems from the impact of the moratorium on deepwater drilling in the Gulf. Although the ban has been lifted, technically, the permitting requirements bring uncertainty about how they will be implemented in practice. This has driven many U.S. E&P companies focused on deepwater drilling to look to less restricted deepwater areas like the West and East coasts of Africa and Brazil.

For more information on how the BDO Natural Resources practice can help companies navigate challenges and take advantage of growth opportunities in the industry, please contact Kevin Hubbard at khubbard@bdo.com.

▶DID YOU KNOW...

U.S. oil and gas drilling during 2010 increased 12% from 2009, but remained below 2008 levels. It is estimated that 37,892 wells were drilled in the United States in 2010, according to the ***American Petroleum Institute***.

During 2010, the number of active deepwater floating rigs worldwide fell to its lowest point since 2004, according to ***ODS-Petrodata***.

Angola, Africa, produces an estimated 1.2 million barrels a day from deepwater drilling, and Nigeria another 600,000. At just under 400,000 barrels a day, Norway is another big producer, and smaller amounts are coming from India, Malaysia and Australia, according to the ***Energy Policy Research Foundation***.

Carbon dioxide emissions peaked in the United States in 2005 and will not reach that level again until the early 2020s, according to the ***U.S. Energy Department***.

Total electricity use in the United States is projected to be 20% higher in 2035 than in 2011. Renewable energy, which was 10% of the mix in 2009, is slated to be 14% in 2035. The use of coal as a fuel is projected to fall to 43% from 45%, according to the ***U.S. Energy Department***.

During December 2010, Congress extended the Section 1603 Investment Tax Credit for renewable energy for 2011. This is projected to increase wind project installations by roughly 50% each year, according to the ***American Wind Energy Association***.

Total global upstream M&A transaction value, including corporate mergers, was $160 billion during 2010, a $16 billion increase from 2009. These transactions were primarily dominated by acquisitions as there were no mergers greater than $10 billion, according to ***IHS Herold***.

By 2020, China plans to double the economic output it produced in 2000 and could be using fully half of the world's energy by 2050, according to the ***president of the China Energy Research Society***.

CALENDAR

MARCH 2011

March 7-11
CERA Week 2011
The Hilton Americas-Houston
Houston, TX

March 27-29
NPRA 2011 International Petrochemical Conference
Grand Hyatt San Antonio
San Antonio, TX

March 28-30
Marcellus Shale Gas Environmental Summit
Renaissance Pittsburgh Hotel
Pittsburgh, PA

APRIL 2011

April 5-6
SPE/IADC Managed Pressure Drilling & Underbalanced Operations Conference
Westin Denver
Denver, CO

April 10-13
AAPG Annual Convention & Exhibition
George R. Brown Convention Center
Houston, TX

April 11-13
IPAA Oil & Gas Investment Symposium – New York
Sheraton New York Hotel & Towers
New York, NY

April 18-20
DUG: The Leading Unconventional Gas Conference in America
Fort Worth Convention Center
Fort Worth, TX

MAY 2011

May 2-5
Offshore Technology Conference
Reliant Park
Houston, TX

May 10-11
International Industry Summit on Mining Performance
Radisson Hotel
Rapid City, SD

May 19
IADC Drilling Onshore Conference & Exhibition
Omni Houston Hotel Westside
Houston, TX

May 23-26
International Oil Spill Conference
Oregon Convention Center
Portland, OR

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