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From:
Sent: Monday, July 11, 2016 2:41:07 PM
To:
Cc:
Bcc:
Subject: FW: Oil and Gas Issue - IDC Preference Issue

I told you that you would have this by last week; sent it to my box by mistake. Here it is; sorry for the delay.

You requested that we provide comments on concerning the intangible drilling and development costs (IDC) preference issue. the that the amount of its hedging is based on reserves and likely production from drilling, assuming that is an important distinction between its hedging transactions and "speculative hedging." That fact is irrelevant, , it "enters into these hedges in order to establish the prices that it will receive with respect to its oil and gas inventory." The key part of the definition

– that is "[i]n the case of oil and gas wells, 'gross income from the property,' means the amount for which the taxpayer sells the oil or gas in the immediate vicinity of the well." While the hedging is not a speculative investment, but is intended as price insurance (or assurance perhaps), it has no connection to the amount for which the taxpayer sells the oil or gas in the immediate vicinity of the well. The oil represented by the hedging contracts is not the oil produced by the taxpayer *from the property*. The gloss over the key connection between the reason for the calculation of gross income from the property made under § 613 (figuring the depletion allowance under § 611) and the specific oil produced from the property. Depletion and gross income from the property by extension are determined on a property by property basis. Depletion with respect to an oil or gas property is dependent on the production and sale of mineral from that property. Oil or gas produced from one property cannot be taken into account in determining depletion on another property. Consequently, no hedging or other transaction that does not concern the actual oil or gas extracted from the property

has any relevance in computing the allowance for depletion, which is, after all, a measure of the diminution of the of the mineral property due to the extraction of the minerals (oil or gas in this case) from the property. So

concerning the price of inventory, limits on amounts of oil represented by the hedging contracts, and examples of can obscure the simple fact that we are not calculating the price ultimately received by the taxpayer after all contracts are closed but the gross income received from the sale of particular oil or gas extracted from a particular property.

Our view on the meaning of § 57(a)(2)(C) is set forth more fully below, in our answer to question 3, that nothing in §§ 57(a), 613(a) or the regulations thereunder limits gross income, arguing that the § 613 reference is only to "gross income" but the definition in § 57(a)(2)(C)(i) by leaving out the word "all" – the definition reads "gross income (within the meaning of section 613(a)) from *all oil, gas, and geothermal properties* of the taxpayer…" so that the reference is again to specific properties producing specific income, rather than to oil and gas income generally, . We believe that § 1.613-3 demonstrates the difference between "gross income" and "gross income from the property." Under that provision, if the oil or gas produced from a mineral property is not sold at the wellhead but is processed, refined, or transported prior to sale, the gross income from the property is assumed to be equivalent to the representative market or field price of the oil or gas before processing, refining, or transportation, *i.e*., the price for which the oil or gas would have been sold in the immediate vicinity of the well. The reasoning underlying this provision is that when the mineral is processed or transported prior to sale, the processing or transportation increases the amount for which the oil or gas ultimately is sold. Although the proceeds from the sale of the refined or transported mineral is gross income to the taxpayer, the amount in excess of the what the raw mineral would have sold for is not taken into account in computing depletion. Instead the taxpayer is required to go back to the wellhead and take into account in computing depletion only the amount for which the extracted mineral would have sold.

The purpose of § 57(a)(2)'s limitation is to limit for AMT purposes the amount of deductible IDC to a percentage of the gross income produced by the properties generating those IDC. That is really the only logical interpretation of the measure of the limitation sought by congress on excess IDCs; it would make no sense to measure the amount of IDCs considered "excess" by a calculation including hedging transactions not related to the oil and gas properties of taxpayer.

an extended analysis of § 613(c), Corn Products (discussed below), and CCA 2009-008. None of this material addresses the fundamental limitation provided by the words "from the property." Section 613(c) relates to mining and § 613(c)(1) states that the definitions therein relate to "property other than an oil or gas well" so any relevance here is only by analogy, and the CCA reaches conclusions . The discussion of Corn Products

again focuses on the court's statements regarding inventory versus investment transactions, which discussion is completely irrelevant to whether hedging transactions in a stated amount of oil that is not being extracted from the taxpayers' oil and gas properties are considered includible within the gross income *from those properties*. Even if one assumes, *arguendo*, that hedging contracts should be treated as "surrogates for the raw material itself" or inventory, as are futures contracts, that conclusion only advances to having oil or gas purchased from a third party. The oil or gas represented by the hedging transactions is still not from the properties and still not within the definition of "gross income from the property" within the meaning of § 1.613-3.

regarding a statement from an uncited 1978 House Report, the legislative history to section 402 of The Energy Tax Act of 1978, Pub. L. 95-618, § 402, 92 Stat. 3175, 3201 (1978), states "The bill also provides that the excess of the intangible drilling and development costs over the amount of those costs that would have been amortizable on the basis of a 10-year life and which further exceed the taxpayer's income from the production of geothermal resources constitutes a tax preference item for purposes of the alternative minimum tax on individuals. To ascertain the amount of the intangible drilling and development costs over the amount amortizable, which is subject to the minimum tax, the taxpayer's income from oil and gas properties and geopressurized methane gas properties is to be determined separately from the calculation of income from geothermal properties." S. Rep. 95-529, at 92, 1978-3 C.B. (Vol 2) 284; See also, H.R.Rep. No. 95-496 (Part III), at 247, 1978-3 C.B. 193. While the statute has changed, that the committee was limiting the preference item to investors in shelters and not to those engaged in the oil and gas business, the committee reports show that the Congress intended that the preference be determined by gross income from the actual properties, even dividing the favored geothermal properties from the less favored oil and gas properties, and not from all transactions in purchased (or hedged) oil.

2. You asked whether the Corn Products' ruling that futures contracts were integral to the taxpayer's inventory system and that gains and losses from transactions involving those futures contracts were therefore ordinary supports that gains and losses from hedging transactions are included within the calculation of "gross income from the property" under § 1.613-3. We view the question before the Court as so different from that at issue here that no analogy can be drawn. The definition of "gross income from the property" in § 1.613-3 is "[i]n the case of oil and gas wells, 'gross income from the property,' means the amount for which the taxpayer sells the oil or gas in the immediate vicinity of the well. If the oil or gas is not sold on the premises but is manufactured or converted into a refined product prior to sale, or is transported from the premises prior to sale, the gross income from the property shall be assumed to be equivalent to the representative market or field price of the oil or gas before conversion or transportation." The definition makes clear that the "gross income from the property" relates to specific oil from a specific well. The purpose of determining gross income from the property is in order to calculate the allowance for depletion under § 611, which as we noted above is determined on a property by property basis, taking

into account with respect to a mineral property only the oil and gas extracted and sold from that property. Thus, while the Supreme Court reasoned from the taxpayer's entering into futures contracts due to its need to ensure a steady supply of corn at a reliable price to concluding that the income or loss from the futures contracts should be considered as part of the taxpayer's inventory cost rather than gain or loss from investment or capital transactions, the issue here is much more narrow. Hedging transactions give the taxpayer price protection or certainty but the hedging contract, even if the amount hedged is based on the amount the taxpayer anticipates extracting from its wells, has no relationship to the particular oil that is extracted from those wells. The definition is focused narrowly on the oil actually extracted and sold, and not on income from oil production generally, because the only reason for determining "gross income from the property" is to calculate the allowance for depletion. Congress borrowed to this definition in section 57(a)(2)(C) in defining "gross income (within the meaning of section 613(a)) from all oil, gas, and geothermal properties of the taxpayer…" in calculating excess intangible drilling cost; this makes perfect sense because the excess IDC at issue are those with respect to "all oil, gas, and geothermal properties of the taxpayer" – that is, the specific IDC for the taxpayer's specific properties that exceed 65 percent of the net income from those specific properties and not some unrelated measure of net income from oil and gas production (which could include income or loss from hedging transactions only tangentially related to the production from taxpayer's properties). This is consistent with the general treatment of

3. You ask whether calculation of net income from oil and gas under § 1.613-5 should include hedging gains and losses. The term "net income from oil and gas" is used in § 57(a)(2)(C) uses that term and does not define the term by referencing § 1.613-5. However, we believe that § 1.613-5 is instructive in limiting the scope of the deductions from gross income from the property to calculate net income from oil and gas. Section 57(a)(2)(C) defines net income from oil, gas, and geothermal properties as "(i) the aggregate amount of gross income (within the meaning of section 613(a)) from all oil, gas, and geothermal properties of the taxpayer received or accrued by the taxpayer during the taxable year, over (ii) the amount of any deductions *allocable to such properties* reduced by the excess described in subparagraph (B) [IDCs] for such taxable year." (emphasis added). The section repeatedly refers to "the properties" as the key part of the definition; Congress could have used a more inclusive phrase such as "from oil and gas operations' but it limited the net income calculation to income from and deductions allocable to the properties. While §57 does not further define what deductions may be allocable to the properties, a similar concept is used in the definition of net income from oil and gas under § 1.613-5.

Section 1.613-5(a) defines taxable income from the property (computed without allowance for depletion) as 'gross income from the property' as defined in § 613(c) and § 1.613-3 and § 1.613-4 less allowable deductions which are attributable to the mineral processes, including mineral transportation, *with respect to which depletion is claimed.* The remainder of the section lists particular items, processes and transportation expenses that are included within the calculation all of which apply to processes applied to that property – as with the gross income from the property

definition, the relevant deductions are all those that relate to the particular property. Section 1.613-5(a) provides that "where a taxpayer has more than one mineral property, deductions which are not directly attributable to a specific mineral property shall be properly apportioned among the properties." The deductions are attributable to several mineral properties and are allocated among them but there is no provision for overhead in that section. Section 1.613-5(c) lists particular items that go into the computation of taxable income from the property. Several items such as a portion of trade association dues (§ 1.613-5(c)(6)) and a reasonable portion of the expenses of selling a refined product are taken into account but there is no provision for including overhead generally or expenses related to, or gain or loss from, transactions not directly related to oil and gas produced and sold. Thus, we believe to the calculation set forth in § 1.613-5 does not support the conclusion that gains or losses from hedging transactions should be included in taxable income from the property.