Oil and gas taxation in the United States

Deloitte taxation and investment guides
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Oil and gas tax guide

Tax professionals of the member firms of Deloitte Touche Tohmatsu Limited have created the Deloitte International Oil and Gas Tax Guides, an online series that provides information on tax regimes specific to the oil and gas industry. The Guides are intended to be a supplement to the Deloitte Taxation and Investment Guides, which can be found at www.deloitte.com/taxguides. For additional information regarding global oil and gas resources, please visit our website:www.deloitte.com/oilandgas
1.0 Summary

The principal U.S. taxes and rates applicable to companies in the oil and gas extraction business are:

- Federal Income Tax 35% (top rate)
- Federal Alternative Minimum tax (AMT) 20%
- Federal Withholding Tax *
  - Dividends 30%
  - Interest 30%
  - Rents and royalties 30%
- State Income Tax ** 0%–10% (approximate)
- State Severance Tax ** 0%–25% (approximate)
- State Sales and Use Tax ** 3%–9% (approximate)

* Subject to reduction under an applicable tax treaty

** Rate comparison is difficult because not all states impose the tax, and/or states may employ different taxing schemes.

2.0 Corporate income tax

2.1 In general

The U.S. federal corporation income tax applies to the worldwide taxable income of a domestic corporation and the taxable income of a foreign corporation that is effectively connected with its U.S. trade or business.

A foreign tax credit may be provided to ameliorate the effect of foreign source taxable income being subject to taxation by more than one country.

Affiliated domestic corporations can essentially elect to be treated as a single entity by filing a consolidated tax return.

Most states impose an income tax, and they generally start with federal taxable income and make adjustments to arrive at state taxable income. The discussion that follows, unless otherwise noted, is largely limited to a discussion of federal income tax concepts.

There are no special income tax regimes for oil and gas companies, such as ring fencing or field-based taxes, like those found in some jurisdictions. Thus, profits and losses from oil and gas activities can generally offset profits and losses from any other business activity conducted by the oil and gas company.

2.2 Rates

A graduated rate schedule applies up to a maximum 35% rate. For corporations with taxable income greater than US$15 million, all taxable income is subject to a 35% rate.

2.3 Taxable income

Taxable income is gross income minus deductions. Gross income is generally all income from whatever source less costs of goods sold. Most ordinary and necessary business expenses of a corporation are deductible in arriving at taxable income.
2.4 Revenue
Income is a broad concept including almost any “accession to wealth.” Common income items in the oil and gas industry are:

• the sale of oil and gas;
• lease bonuses;
• royalty income;
• overriding royalty income;
• income from a net profits interest;
• some types of production payments; and
• gains on the sale of oil and gas property.

2.5 Deductions and allowances
Leasehold costs
An oil and gas operator acquires the right to drill for oil and gas on the owner’s land by entering into an oil and gas “lease”. Costs incurred to acquire a lease are capitalized and recovered through depletion deductions. Such costs can include, amongst other things:

• bonus payments;
• auction bid payments;
• the purchase price of an existing lease;
• geological and geophysical (G&G) costs incurred before August 9, 2005;
• seismic work;
• salaries of landmen;
• intangible drilling costs (IDC, see below);
• title transfer fees; and
• attorney fees.

Geological and geophysical costs
Domestic G&G costs are capital expenditures that a taxpayer is generally allowed to amortize and deduct ratably over a 24-month period. For a “major integrated oil company”, the amortization period is seven years. Foreign G&G costs are capitalized and recovered through cost depletion.

Intangible drilling and development costs
The intangible costs an operator incurs to drill or develop oil and gas wells are major expenditures and can include the following:

• costs of drilling;
• wages;
• supplies;
• drilling mud;
• cementing;
• logging;
• crop damage;
• survey and seismic to locate well sites;
• repairs;
• fuel;
• site preparation; and
• road construction.

Although IDC are capital expenditures, taxpayers (other than integrated oil companies) are allowed to deduct currently such costs associated with domestic wells by making an election with their tax returns. Failure to make the election results in recovery of the IDC through cost depletion or depreciation. If properly elected, a taxpayer can make an annual election to capitalize some or all of the deductible IDC. If capitalized under this provision, the IDC is recovered over 60 months.

Integrated oil companies are required to capitalize 30% of IDC and amortize the cost over 60 months.

For wells located outside the United States, taxpayers must capitalize IDC and recover the cost over either a 10-year period or, at the taxpayer’s election, through cost depletion.
Even if IDC is initially capitalized, taxpayers can elect to deduct such unamortized costs associated with the drilling of a non-productive well as “dry hole” costs.

**Workover costs**
Workover operations generally involve the use of a special drilling rig to “rework”, stimulate, or restore production from a particular well. Such costs associated with improving, maintaining, or sustaining production from currently producing reserves are generally deductible as ordinary and necessary business expenses.

**Depreciation**
The cost of lease and well equipment (surface casing, “Christmas Tree”, pumps, motors, production tubing, etc.) is generally depreciated using the modified accelerated cost recovery system (MACRS), which is based on class lives and recovery periods provided in Internal Revenue Service publications. A 200% (or 150%) declining balance method can be used, but the straight-line method can be elected instead. Many assets used by oil and gas producers to drill wells and produce oil and gas have a recovery period of seven years. However, for such assets used predominately outside the United States, taxpayers are required to depreciate the costs over 14 years using the straight-line method.

The cost of tangible property also can be recovered by using the unit of production method, which is computed similarly to cost depletion for leasehold costs (see Depletion below).

**Depletion**
Leasehold costs are generally recovered using the cost depletion method by which the adjusted basis of property is “depleted” and allowed as a deduction as the associated mineral reserves are depleted. The cost depletion amount is computed by dividing the adjusted basis of the property by the number of mineral units at the end of the year plus the number of units sold during the year and multiplying that result by the number of units sold during the year.

Instead of using the cost depletion method, independent producers and royalty owners (i.e., taxpayers who are not also refiners or retailers) who own property located in the United States are permitted to compute depletion by using the percentage depletion method. (Thus, foreign property is not eligible for percentage depletion). The percentage depletion deduction is generally 15% of gross income from the property, figured on a property-by-property basis, and is not limited to the taxpayer’s adjusted cost basis in the property. This rate applies to a taxpayer’s average daily production of up to 1,000 barrels of oil or, alternatively, 6 million cubic feet of gas. If cost depletion results in a greater deduction on a specific property, however, cost depletion must be used.

**Manufacturing deduction**
See Section 4.2 — Manufacturing.

**Decommissioning costs**
Oil and gas taxpayers are obligated to remove offshore platforms upon abandonment of the well or termination of the lease. Though it may be possible for accrual basis taxpayers to make reasonable estimates of future costs, such costs cannot be deducted for tax purposes until the removal obligations are performed.

**2.6 Losses**
Loss deductions are allowed for property proved to be “worthless”. For example, a loss may be allowed for a lease that terminates at the expiration of its primary term, or for failure to make delay rental payments. See Section 6.4 — Abandonment.

An unutilized overall net operating loss (NOL), defined as the excess of allowable deductions over gross income, can be carried back two years and forward 20 years. The amount of deduction can be limited in the event of an “ownership change” of the taxpayer.

**2.7 Foreign entity taxation**
A foreign corporation is generally subject to federal income tax on its income effectively connected with its U.S. trade or business (“effectively connected income” or “ECI”). In addition, a foreign corporation may be subject to branch profits tax of 30% of the “dividend equivalent amount” (essentially when branch earnings are “returned” to the home country), and a branch-level interest tax of 30% of “excess interest” constructively paid to such foreign corporation by its U.S. branch. In some cases, an income tax treaty may reduce or eliminate the statutory U.S. tax on a foreign corporation, such as by limiting the tax on ECI so that it covers only ECI attributable to a permanent establishment in the United States, and by reducing the 30% tax rate on dividend equivalent amounts and excess interest (or eliminating the tax entirely). Income tax treaties should be consulted to determine if treaty benefits are available in a particular case.
A foreign corporation is generally not taxable on gains from the sale of many types of personal property, unless derived in connection with the conduct of a U.S. trade or business. However, under the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) a gain (or loss) from the disposition by a foreign corporation of a “U.S. real property interest” (USRPI), whether or not actually connected with a U.S. trade or business, is treated as ECI and is subject to tax. In many circumstances, stock of a domestic corporation that conducts U.S. oil and gas exploration and production activities will be a USRPI.

Certain passive/mobile types of income earned by a controlled foreign corporation (CFC) (e.g., a foreign corporation wholly owned by a domestic oil and gas corporation) are potentially subject to current income taxation in the hands of the domestic parent. “Foreign base company oil related income” is one such type of income and is comprised of essentially all non-U.S. source income attributable to operations of the CFC after the wellhead. It thus excludes income earned from the extraction of oil and gas from wells, but includes such items as income derived by refining oil and gas into their primary products, income earned from the transportation of oil and gas products, and income derived from the retail sale of gasoline. Important exceptions can further limit current U.S. taxation of this income.

3.0 Other corporate income tax

3.1 Additional profits taxes
In addition to the federal corporation income tax, a corporate taxpayer may be subject to the AMT. In broad terms, the AMT utilizes a separate tax base in which certain “accelerated” preference deductions and other items used to determine regular taxable income are adjusted to arrive at a higher (but can be lower) alternative minimum taxable income (AMTI), to which a 20% tax rate is applied (the “tentative minimum tax”). Potential adjustments to items particularly relevant to oil and gas companies to arrive at AMTI include:

- IDC;
- the last-in, first-out (LIFO) method of computing costs of goods sold;
- depreciation; and
- adjusted current earnings (an adjustment designed to capture a portion of a company’s financial earnings in excess of AMTI).

The excess of the tentative minimum tax over the regular tax, if any, is the AMT.

3.2 State taxation
Oil and gas companies are potentially subject to state and local income taxation, which can be a significant cost. Generally, in their imposition of a net income tax, states and other taxing jurisdictions will follow versions of the Internal Revenue Code to determine taxable income and make adjustments specific to their respective policy decisions. However, some states impose a gross receipts or franchise tax in lieu of, or in addition to, an income tax.

Once taxable income is determined, each state will apportion the income using an apportionment formula specific to that state. Some states have their own depletion methods and/or their own elections involving depletion. Also, some states have special taxing regimes for oil and gas companies that force worldwide filings whether or not the income of the foreign affiliates are effectively connected. While, as noted above, the states generally follow the federal rules in determining income, there are significant deviations. One example of such a deviation is the federal consolidated regulation rules that treat a group of related corporations as a single taxpayer; many states do not follow the federal consolidated return rules and treat each individual corporation as a separate taxpayer. Therefore, transactions that may be afforded tax-free treatment for federal income tax purposes may be taxable in some states. A discussion of the many state income statutes and rates that could apply and the various states’ complex apportionment and allocation schemes is beyond the scope of this guide.

3.3 Local taxation
In many states, political subdivisions such as counties, cities, and municipalities are permitted to impose taxes, which may include income, gross receipts, and transaction taxes as well as various fees. Generally, locally imposed taxes are not significant compared with the federal and state imposed burdens. However, in certain parts of the country, exploration and development activities are now being subjected to user fees on a well-by-well or property-by-property basis, which can affect the economics of an investment. In several of these jurisdictions, the tax regime is changing very rapidly. It is important to analyze the economic impact of these evolving regimes if a project is being planned or executed in newer, energy-producing states.
4.0 Tax incentives

4.1 Research and development
Qualified research and experimental (R&E) expenditures are eligible for the R&E tax credit. The current R&E credit regime (in effect through 12/31/2013) allows a company to choose the “old” method or the new alternative simplified credit (ASC) method. The old method involves complicated “base amount” calculations and the credit is 20% of the amount of expenditures exceeding the “base” amount (13% if the taxpayer elects to take the reduced credit in lieu of offsetting the calculated credit against current year R&E expenses). The ASC method is simpler because it eliminates base period complexities dealing with gross receipts and historical R&E spend for the years 1984 to 1988, and has broader applicability. Under the ASC method, a taxpayer calculates its average R&E expenditures for the three prior tax years. Once the three-year average is calculated, the taxpayer may receive a credit for current-year R&E expenditures exceeding 50% of the prior three-year average. The R&E credit under the ASC method is 14% (9.1% if the taxpayer elects to take the reduced credit in lieu of offsetting the calculated credit against current year R&E expenses).

4.2 Manufacturing
The generally applicable domestic production activities deduction is also available to the oil and gas industry. Specifically, the production of oil and gas is an extraction activity that qualifies for the deduction. The deduction is limited to the lesser of 6% of qualified production activities income (QPAI), 50% of production wages, or taxable income. QPAI is domestic production gross receipts (DPGR) less the cost of goods sold and other expenses and losses or deductions allocable to DPGR. Expenses included in the calculation of QPAI are all expenses incurred for the production of oil and gas; IDC, depletion, interest expense, and properly allocable overhead.

4.3 State
States may offer a research credit or give tax incentives to continue production of marginally producing properties. For example, California offers a research and development credit modeled after the federal credit and Alaska offers significant exploration and production credits. Some other states may waive production taxes, property taxes, or both. Some states also have employee-related credits and investment credits. Certain states and localities are also open to negotiated incentives for investment and job creation activities.

5.0 Payments to related parties

5.1 Transfer pricing
Transactions between controlled taxpayers involving oil and gas companies are subject to the generally applicable complex transfer pricing rules and regulations in which the “best method” is used to determine an arm’s length price for a particular transaction.

5.2 Thin capitalization
There is no safe harbor debt-to-equity ratio that can be used to determine debt treatment of an instrument. The debt-to-equity ratio is merely one of many factors taken into account by the Internal Revenue Service and the courts in determining whether a particular instrument is debt or equity. For example, it would be unlikely that a start-up oil and gas exploration company with no production could support an instrument as debt irrespective of the debt-to-equity ratio.

5.3 Interest deductibility
There are no particular interest deductibility rules or limitations that apply specifically to oil and gas companies.

The deductibility of interest paid or accrued by a domestic company to a foreign related company (or to a third-party on debt guaranteed by a foreign related company) can be limited if the domestic corporation’s debt-to-equity ratio exceeds 1.5:1, and its net interest expense exceeds 50% of its adjusted taxable income.
6.0 Transactions

6.1 Capital gains
There are detailed netting procedures and recapture of deduction rules for capital gains and losses and gains and losses arising from the disposition of trade or business assets (which would generally include oil and gas leases and equipment). Recaptured deductions and a corporation’s net capital gains are subject to tax at the regular income tax rates. Net capital losses cannot be deducted, but can be carried back three years and over five years to offset capital gains. Net losses from the disposition of trade or business assets can be deducted as ordinary losses.

As indicated above under Section 2.7 – Foreign entity taxation, gain on the disposition of stock of a domestic oil and gas corporation by a foreign owner may be taxable by the United States.

6.2 Asset disposals
As described above, when oil and gas assets are sold complex recapture rules apply to treat all or a portion of the gain as ordinary income. Gain attributable to lease and well equipment is subject to depreciation recapture. Gain attributable to the sale of oil and gas properties must generally be treated as ordinary income to the extent of previously deducted IDC and depletion to the extent the depletion reduced the adjusted basis of the properties sold. Percentage depletion claimed under the exemption for independent producers and royalty owners that exceeds the tax basis in a property sold is not subject to recapture.

6.3 Like-kind exchanges and involuntary conversions
Generally, oil and gas properties are real estate and they can be exchanged tax-free for other real estate (subject to special recapture rules if non-oil and gas property involved). Depreciable tangible property (e.g., lease and well equipment) can be exchanged tax-free for like-kind tangible property described in certain asset or product classes. Similar rules allowing for tax-free treatment apply if domestic property is involuntarily or compulsorily converted into similar property. Real property located in the United States cannot be exchanged tax free for real property located outside the United States. Similarly, personal property used predominantly in the United States cannot be exchanged tax-free for personal property used predominantly outside the United States.

6.4 Abandonment
For oil and gas properties established to be worthless and abandoned for tax purposes, the adjusted basis remaining in the property may be deducted as a trade or business loss.

6.5 Sharing arrangements and farm outs
Farm outs and carried interests are two common types of sharing arrangements that, if structured properly, can be entered into with little or no income tax consequences. However, the payment of a disproportionate share of the costs, representing an amount in excess of a party’s percentage interest in the oil and gas property, may not be currently fully deductible under these arrangements. Therefore, it is not unusual to structure these arrangements as partnerships under U.S. tax law, which provides more flexibility with respect to allocating deductions. See Section 9.1 – Choice of business entity.

7.0 Withholding taxes
U.S. federal law imposes a tax of 30% on the gross amount of most types of U.S. source income of a foreign corporation or non-resident alien individual that is not effectively connected with the conduct of a U.S. trade or business (“non-ECI”). Exceptions in some cases include gains from the sales of certain types of property, certain bank account interest, short-term original issue discount, and portfolio interest. To collect this tax, the payers of such income generally must deduct and withhold 30%.

7.1 Dividends
The 30% withholding tax on U.S. source non-ECI generally applies to dividends from domestic corporations, unless the payer can reliably associate the payment with documentation upon which it can rely to establish that a reduction of, or exemption from, the tax (e.g., due to an applicable income tax treaty) applies. In some cases the FIRPTA-related withholding may be imposed at rates higher than 30%. 
7.2 Interest
The 30% withholding tax on U.S. source non-ECI generally applies to interest paid by domestic corporations and non-corporate U.S. residents, unless the payer can reliably associate the payment with documentation upon which it can rely to establish that a reduction of, or exemption from, the tax (e.g., due to an applicable income tax treaty) applies.

7.3 Rents and royalties
The 30% withholding tax on U.S. source non-ECI generally applies to rents for property located in the United States, and royalties for the use of property in the United States, unless the payer can reliably associate the payment with documentation upon which it can rely to establish that a reduction of, or exemption from, the tax (e.g., due to an applicable income tax treaty) applies.

7.4 Other
In the case of a disposition of a USPRI by a foreign person, the transferee generally must deduct and withhold 10% of the amount realized on the disposition. In some cases, other FIRPTA-related payments can be subject to withholding at a higher rate.

If a partnership has ECI and any portion of such income is allocable to a foreign partner, the partnership must pay a withholding tax on such portion at the highest applicable rate (currently 35% for corporations, 39.6% for individuals).

7.5 Tax treaties
The United States has a broad network of tax treaties that provide various types of relief from U.S. tax rules. In appropriate cases, withholding agents are permitted to withhold reduced amounts of tax from payments, or make payments without withholding tax, based on the treaty benefits to which beneficial owners of the payments are entitled.

8.0 Indirect taxes

8.1 Value added tax, goods and services tax, and sales and use tax
There are no federal or state value-added taxes.

Most states and many political sub-divisions and taxing authorities (cities, counties, transit authorities, etc.) impose sales taxes on retail sales of particular goods and some services, with general exemptions available for items involving further manufacture or resale. Sales taxes are collected by the seller when the taxable item or service is sold. A use tax is a self-assessed tax by the purchaser of an item and is imposed on the storage, use, or other consumption of a purchased taxable item for which sales tax has not already been charged by the seller. Sales and use tax rates typically range from 3% to 9% of the fair value of the taxable item sold or service performed. Various states offer sales and use tax exemptions for mining and/or manufacturing activities that may benefit oil and gas companies. These exemptions may apply to equipment, labor, or both, and will often depend on the nature of the service or activity and the relevant step of the production process in which such service or activity occurs.

Certain states impose a tax similar to a value added tax where a low rate is imposed on every transaction. Such taxes are imposed in Ohio (commercial activity tax) and Washington State (Business and Occupation tax).

8.2 Import, export, and customs duties
All goods imported into the United States are subject to declaration and potential payment of duties and various fees upon import. The amount of duties owed is dependent on several factors including; the type of good being imported, the value of the good, the quantity, and the country of origin of the good. It is the responsibility of the importer of record to exercise reasonable care when making import declarations.

Duty rates in the oil and gas industry can be either ad valorem or specific (a specific monetary amount per certain quantity or weight), or a combination of the two. For example, many goods imported by the oil and gas industry are classified in chapter 27 of the US Harmonized Tariff Code. Duty rates in this chapter vary. For example, liquefied natural gas is duty free; certain greases have a duty rate of 5.8%; while other types of greases carry a duty rate of 1.3 cents per kg + 5.7%.
It is important to note that many oil and gas companies can benefit from the use of Foreign Trade Zones as well as the use of numerous Free Trade Agreements. Both of these mechanisms may potentially be utilized to help oil and gas companies address their duty burden.

The United States does not assess tax on exports. However, the United States does have very strict export controls regulations, many of which are applicable to the oil and gas industry. As a U.S. exporter, companies must be aware of the amount of export control placed on their product and technology and what the limitations are for exporting that product and/or technology to certain countries, people and/or institutions.

8.3 Excise tax
Excise taxes are imposed on the sale of various fuel products when they are sold, removed from a terminal, or imported into the United States. Some of the fuel products subject to the tax include, but are not limited to: gasoline, diesel, kerosene, alternative fuels, and gasoline blendstocks.

Excise taxes are imposed at the federal and state levels. Each jurisdiction has varying rates and differs on the point of taxation, or when the product is subject to tax. The excise tax is a volumetric tax.

Environmental taxes also apply at the federal and at state levels to various petroleum products. These include, but are not limited to: crude oil received at a U.S. refinery; petroleum products entering into the United States for consumption, use, or warehousing; certain uses of crude oil; and the exportation of domestic crude oil.

8.4 Severance tax
Severance tax (sometimes referred to as gross production tax) is imposed on the extraction of non-renewable resources. It may be imposed on the severing of oil, natural gas, coal, uranium, and timber. Currently, at least 36 states impose a variation of a severance tax, and 31 states specifically levy the tax on the extraction of oil and gas. Severance tax is imposed on producers or anyone with a working or royalty interest in oil or gas operations. The tax is typically imposed as a percentage of a given value of the product extracted.

8.5 Stamp tax
The United States does not impose a stamp tax. Some states may impose a real estate transfer tax or mortgage tax. These taxes are generally imposed on either the transfer of real property, the recordation of an instrument evidencing the transfer of real property, or the recordation of a mortgage secured by real property. Certain intercompany transfer of real estate could trigger these taxes in certain states.

8.6 State and municipal
Various states impose other transaction taxes on services or other industries. For example, Texas imposes a 2.42% tax on service providers of certain oil well services (oil well service tax), and Mississippi imposes a 3.5% tax on all non-residential, commercial contracts, regardless of whether or not the owner is a governmental, exempt, or non-profit entity (contractor’s tax). Many states and municipalities impose ad valorem taxes on real or tangible personal property located in the jurisdiction on a specified date. Real property and tangible personal property are given an assessed value and tax is assessed as a percentage of that value. Generally, property is assessed according to its status and condition on January 1 of each year. The value of real and tangible personal property must be determined by the generally recognized appraisal methods.

9.0 Other

9.1 Choice of business entity
Many oil and gas ventures involve unincorporated joint ventures or contractual arrangements, which are generally treated as partnerships for income tax purposes. For example, the typical joint operating agreement can result in a tax partnership with the interest owners considered tax partners. Members of the unincorporated joint venture can “elect-out” of the partnership provisions of the Internal Revenue Code under certain conditions, including reserving the right to, and taking production from, the oil and gas property in-kind.

Joint venture participants sometimes prefer to operate in partnership form. Partnerships are considered pass-through entities for tax purposes, meaning that the income and deductions are reported by the partners and taxes paid on their own tax returns. However, a partnership must still file a U.S. federal partnership information return to report the partnership’s and partners’ income and deductions, and there are complex rules that must be followed in regards to partners’ capital accounts. If there are any foreign partners in the partnership, tax withholding and reporting may be required. Most states treat partnerships as flow-through entities, requiring state information returns to be filed.
However, some states impose partnership entity-level state taxes or require the partnership to withhold, remit, and file state reports on partner distributions to non-resident or foreign partners.

Many investors in tax partnerships or “elect-out” arrangements are individuals. Many rules apply to individuals that do not generally apply to corporations. For example, certain rules can limit an individual’s ability to deduct losses from an oil and gas activity in any given year to the amount the individual has “at-risk” with respect to the activity or, if the activity is a “passive activity”, to the extent of income from other passive activities. An in-depth discussion of these rules or other rules affecting individuals who invest in oil and gas activities is beyond the scope of this guide.

Corporations and limited liability companies are also used to conduct oil and gas operations.

Many foreign parented multinational oil and gas companies conduct oil and gas operations in the United States through domestic corporations.

Ultimately, the choice of entity is driven by commercial and legal considerations, as well as tax.

9.2 Foreign currency

Domestic corporations and “branches” of foreign corporations that produce income or loss that is treated as effectively connected with the conduct of a U.S. trade or business are required to use the U.S. dollar as their functional currency.
10.0 Oil and gas contact information

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