Representation without Taxation

How Natural Gas Producers Escape Taxes in Pennsylvania

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Natural gas drillers in Pennsylvania pay very little in state and local taxes, despite industry claims to the contrary. In tax year 2008, the oil and gas industry[i] paid $38.8 million in Pennsylvania state business taxes.[ii]

Of the 783 companies to file corporate net income tax returns, only **15%** owed any tax. A significantly larger number of drillers — including nine of the top 10 permit holders in the Marcellus Shale — structure their businesses as limited liability companies (LLCs) or limited partnerships (LPs). This allows them to attract investment capital from individuals who avoid the corporate net income tax altogether and pay the much lower personal income tax on their share of the LP or LLC's profits, which lowers the effective tax rate for the LLC or LP.

In 2008, 120 companies paid $17.8 million in corporate net income taxes. 51% of companies had capital stock and franchise tax liability, paying $8 million. While a greater proportion (56%) of LLCs and partnerships had tax liability, they paid in total $13 million in personal income taxes.

According to the Pennsylvania Department of Revenue, drillers in the Marcellus Shale paid $44.4 million in sales and use tax, corporate net income tax and capital stock and franchise tax in 2009.[iii]

Drilling companies enjoy favorable tax treatment in the Commonwealth. They are exempt from property taxes on oil and gas reserves, and most of the equipment used in the drilling process, the largest expense, is exempt from the state sales tax.

Table 1. Pennsylvania Business Taxes Attributed to Natural Gas Drillers (Tax Year 2008)

Tax Type	Tax Paid	Returns with Tax	Total Returns	% with Tax
Corporate Net Income Tax	$17.8 million	120	783	15.3%
Capital Stock and Franchise Tax	$8.0 million	421	824	51.1%
Personal Income Tax	$13.0 million	818	1,458	56.1%
Total[iv]	$38.8 million			

Source. Pennsylvania Department of Revenue

The Marcellus Shale Coalition, an industry group, claims that natural gas producers already pay significant state and local taxes in Pennsylvania. For example, former Governor Tom Ridge, whose lobbying firm promotes the Marcellus Shale Coalition, recently said:

> *"In just two short years, this ancient rock bed of quartz and calcite has helped our state generate more than 75,000 new jobs, and in the process helped the state generate more than*

$1 billion in revenue to state and local governments, at a time when those resources have never been needed more."[v]

This claim is not supported by any evidence that we can verify, particularly not from the oil and gas drillers, themselves.

Special Tax Breaks Abound for Drillers

On paper, natural gas drillers are subject to many of the same taxes as other businesses operating in Pennsylvania. But a closer look reveals that a myriad of incentives and exemptions cut the federal, state and local tax bills of the Commonwealth's gas drillers.

Federal Incentives Reduce Drillers' Income Taxes

Oil and gas companies receive many federal tax incentives that can sharply reduce their federal income taxes and, in turn, cut their state tax payments.[vi] These incentives also reduce the state income taxes that drillers pay, regardless of whether they are structured as a corporation that pays the corporate net income tax on profits or as individuals in an LLC/LP that pay the personal income tax.

Federal deductions and credits, include:

- Immediate write-off of intangible drilling costs (estimated to be 60% to 80% of the well cost) and intangible completion costs (around 15% of the total well cost);
- Yearly well depletion allowance equal to 15% of gross revenue, without regard to real costs incurred;[vii]
- A tax credit of $0.50 per thousand cubic feet (MCF) of natural gas from "marginal wells" with production of 90 MCF;
- A deduction of up to 9% from net income for domestic production activities — which includes the production of natural gas and oil;[viii]
- Immediate expensing of capital expenditures (equipment, buildings, vehicles, computer hardware) through federal "bonus depreciation."

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Corporate Tax Loopholes Allow Drillers to Cut Taxes Even Further

Loopholes in Pennsylvania's antiquated corporate tax system allow drilling corporations more ways to reduce their tax bills. By using Delaware Holding Companies, management fees, and non-

market-based transfer prices[x] to shift profits out of state, companies doing business in Pennsylvania can easily reduce their corporate tax liabilities here.

This is one reason why 85% of the drilling companies that filed corporate tax returns in 2008 paid no corporate income taxes at all.

Most Drillers Use Pass-Through Entities to Reduce State Tax Bills

Natural gas drilling projects are often set up as LLCs or LPs to attract investment and reduce risks for investors. This is a helpful feature if your business has inherent risks, such as natural gas development.

One important feature of organizing as an LP or LLC is that the income from the project "flows" back to the owner — whether that is an individual or a corporation — and the owner pays the tax. As a result, shares that are owned by individuals are subject to the 3.07% personal income tax rate, rather than the 9.99% corporate net income tax rate.

Nine of the top 10 permit-holding companies operate as one of these so-called "flow through" entities (see Table 2). At least 80% of the total number of permit holders are now operated by LLCs or LPs.[xi]

Table 2. Top 10 Marcellus Shale Drillers by Number of Permits (March 2011)

Rank	Company	Headquarters	Number of Permits
1	CHESAPEAKE ENERGY	OKLAHOMA CITY. OK	1,265
2	RANGE RESOURCES	FORT WORTH, TX	724
3	TALISMAN ENERGY	CALGARY, AB	631
4	ROYAL DUTCH SHELL (SWEPI AND EAST RESOURCES)	HOUSTON, TX	578
5	CHEVRON (ATLAS)	SAN RAMON, CA	443
6	ANADARKO	HOUSTON, TX	297
7	EOG RESOURCES INC.	HOUSTON, TX	285
8	ULTRA RESOURCES, INC.	ENGLEWOOD, CO	277
9	CONSOL ENERGY (CSX GAS)	CANONSBURG, PA	274
10	EXCO RESOURCES	DALLAS, TX	264

Note. Shaded companies are operating as LLCs or LPs in Pennsylvania

Sources. Permits by Operator from Pennsylvania Department of Environmental Protection, determination of operating status by the Pennsylvania Budget and Policy Center.

In 2008, more than twice as many companies filed personal income tax returns than filed corporate tax returns. (see Table 1). More than six times as many personal income tax payers reported tax liability than did corporate tax filers: 818 vs. 120. Clearly, in Pennsylvania, much of the income from oil and gas is being taxed at the significantly lower personal income tax rate.

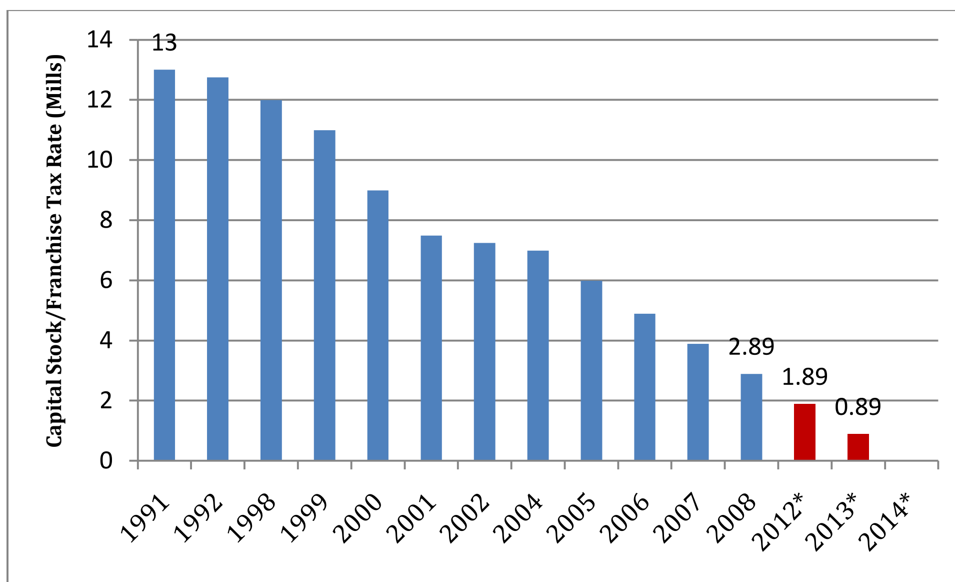
Capital Stock and Franchise Tax Being Phased Out

Whether organized as a regular corporation or an LLC/ LP, drillers are likely subject to the state's capital stock and franchise tax. This is a tax on the net worth of a business and its average net income over the past five years.

While drillers paid $8 million in capital stock and franchise taxes in 2008, this levy's days are numbered. Since 1998, the tax rate has been steadily reduced from 12.75 mills to the current rate of 2.89 mills. The rate is scheduled to drop again to 1.89 mills in 2012 and to be fully eliminated in 2014.

This will amount to yet another tax break for gas drillers in Pennsylvania.

Table 3. Capital Stock and Franchise Tax Rate by Effective Tax Year



Source. Pennsylvania Department of Revenue, *2010 Tax Compendium*

Drilling Equipment Exempted from Sales Tax

Supplies and equipment directly used in manufacturing, including oil and gas production, are exempted from the state sales tax.[xii] This means that fracking chemicals, drilling equipment, pipes used to convey gas to processing plants, testing equipment, and pollution control devices are all tax free in Pennsylvania.

Drillers do pay tax on goods not directly used in the manufacturing process, such as office chairs and computers. Drilling vehicles purchased for use in Pennsylvania should be subject to the sales tax, but with so many drillers hailing from places like Texas and Oklahoma, it is unclear where the tax is being paid.

This manufacturing exemption is not universal among the states. In Texas, for example, most equipment, supplies, repair services and other contracted well services are subject to sales tax.[xiii]

Gas Reserves Not Subject to Property Taxes

A 2002 court case in Pennsylvania created a major tax loophole in which oil and gas reserves are no longer subject to local property taxes.[xiv] While this could be corrected with legislative action, the loophole remains. Other mineral deposits, including coal and gravel, are subject to property taxes.

Prior to 2002, local governments had the ability to tax these deposits, and they were an important source of local revenue in Southwestern Pennsylvania, as they are in Texas, West Virginia, and Wyoming.

In many states, property taxes are assessed on vehicles, equipment, inventories, and supplies used in the drilling process In Pennsylvania property taxes are limited to buildings and land — and tax rates have to be the same as they are on residential property.[xv]

Other State and Local Tax Breaks for Industry

- Drillers don't have to pay local business privilege taxes as gas drilling is considered "manufacturing" and is exempted.
- State and local hotel taxes are waived on the long-term rental of living quarters for industry workers shipped in to Pennsylvania from Texas, Oklahoma and other energy-rich states.
- Net profits earned by corporations and income passed through to owners via Sub-chapter S corporations are exempt from local earned income taxes.

Comparison of Taxes on Gas Drilling in Various States – 2009

As evident in Table 4, state and local governments in Louisiana, Texas, and West Virginia see a much larger direct return (in the form of tax revenue) from oil and gas drilling than is realized in Pennsylvania. Drillers in those states have corporate taxes as well as drilling taxes and property taxes on oil and gas reserves.

In 2009, Texas had about 34 times as much oil and gas drilling as Pennsylvania[xvi], but took in 200 times as much in taxes from the industry than the Commonwealth. West Virginia collected four times as much in taxes on the industry than Pennsylvania, while Louisiana took in more than 18 times as much.

Table 4. Comparison of Taxes on Oil/Gas Drillers by Selected State, 2009 (2008, Texas) ($ millions)

	Louisiana	Pennsylvania[xvii]	Texas[xviii]	West Virginia[xix]
Property	$150[xx]	Data Not Available[xxi]	$3,031	$97
Drilling Tax - Oil	$378[xxii]	-	$1,437	*
Drilling Tax - Gas	$292	-	$2,685	$86[xxiii]
Sales	Data Not Available	$11	$926	Data Not Available
Business Taxes	Data Not Available	$33[xxiv]	$711	Data Not Available
Oil Well Servicing	0	-	$50	-
Total	**$820**	**$44**	**$8,840**	**$183**

Conclusion

Despite claims to the contrary, the natural gas drilling industry paid very little in taxes in 2008 and 2009. Generous federal tax incentives for energy production significantly reduce the state tax liability for most drillers. The appreciable and welcome economic activity from gas drillers has not resulted in significant tax payments to the Commonwealth.

Virtually every other state with natural gas reserves is able to marry robust economic growth with a significant increase in revenue to support education, health care, the environment and other important investments that improve the state's economy over the long-term. Pennsylvania should do the same.

Pennsylvania should modify its tax system as follows:

- Adopt a single statewide drilling tax. This would ensure ease of administration for drilling companies and create a predictable tax liability over the life of the well. A single statewide tax will allow for an equitable distribution of revenue to address local impact, the environment and core public services. The tax should not include tax breaks or rate cuts in the early years of well production. There is little evidence that these types of tax incentives lead to increased production, but they would significantly diminish revenue generated by a drilling tax.
- Restore local governments' ability to assess property taxes on gas and oil reserves using a single statewide assessment methodology.
- Consider allowing local governments to adopt a personal income tax rather than an earned income tax to better capture local economic activity.

ENDNOTES

[i] Oil and gas producers are defined as being in either the oil and gas extraction business or support activities for mining, which includes services for the oil and gas business.
[ii] Data queried by the Pennsylvania Department of Revenue in 2009 for tax year 2008. Included in the figures are tax payments from firms in the Oil and Gas Exploration (NAICS 2111) and Support Activities for Mining (includes oil and gas) (NAICS 2131) industries.
[iii] Commonwealth of Pennsylvania, *Governor's Executive Budget 2011-12* page A.1.11.
[iv] The total number of companies is not provided due to likely double counting. Corporations are required to file both corporate net income tax and capital stock and franchise tax returns. S-corporations, limited liability companies, and limited partnerships are required to file capital stock and franchise tax returns. Income from these entities flows to the owners (whether they are corporations or individuals) who pay the income taxes due.
[v]Governor Tom Ridge, "Commitment to the community," *Marcellus Quarterly*, Spring 2011, p. 16 http://content.yudu.com/Library/A1rdb8/MarcellusQuarterlySp/resources/index.htm?referrerUrl=http%3A%2F%2Fwww.yudu.com%2Fitem%2Fdetails%2F300925%2FMarcellus-Quarterly--Spring-2011
[vi]Salvatore Lazzari, *Oil and Gas Tax Subsidies: Current Status and Analysis (RL33763)*, Congressional Research Service, February 27,2007, http://ncseonline.org/NLE/CRSreports/07March/RL33763.pdf.
[vii] http://www.groco.com/readingroom/oil_gasdepletion.aspx

[viii] Grant Thorton, "Section 199 – Domestic Production Activities Deduction, (accessed April 13, 2011) http://www.grantthornton.com/portal/site/gtcom/menuitem.91c078ed5c0ef4ca80cd8710033841ca/?vgnextoid=f90a7c2ad6ac5010VgnVCM100000308314acRCRD.
[ix]Nanette Barnes, "What U.S. Companies Really Pay in Taxes, *Bloomberg Businessweek*, April 23, 2009 http://images.businessweek.com/ss/09/04/0423_corporate_taxes/26.htm.
[x] Transfer prices are used when related companies buy or sell goods and services to each other. As many of these transactions are not on the open market, the prices assigned can affect how profits are distributed between the companies. For example, a natural gas driller could sell gas to a related pipeline company for a below market price, lowering the driller's profits.
[xi] A complete list of the 75 companies with Marcellus Shale permits can be found here: http://www.pennbpc.org/sites/pennbpc.org/files/MARCELLUS-Active-Operators-Mar-11-by-type.pdf.
[xii] For a full description of the state's manufacturing exemption for sales tax, see http://www.pacode.com/secure/data/061/chapter32/s32.32.html.
[xiii] Texas Oil and Gas Association, *Fueling the Texas Economy*, 2009.
[xiv] *Indep. Oil & Gas Ass'n of Pa. v. Bd. Of Assessment Appeals*, 814 A.2d 180 (Pa. Dec. 19, 2002) (oil and gas interests not subject to real estate taxation by counties not specifically included in real estate.
[xv] Pittsburgh's Future, "Improving Business Taxes," accessed April 14, 2011, http://www.pittsburghfuture.com/businessclimate/businesstaxes.html.
[xvi] This figure is based on total oil and natural gas production (converted to barrels of equivalent) in 2009 as reported by the U.S. Energy Information Administration.
[xvii] Commonwealth of Pennsylvania, *Governor's Executive Budget 2011-12* page A.1.11. Split confirmed by data provided by the Pennsylvania Department of Revenue to Harrisburg Patriot-News Deputy Editorial Page Editor.
[xviii] Texas Oil and Gas Association, *Fueling the Texas Economy*, 2009. Data are for 2008; data breaking down Texas drilling tax revenue from natural gas production and oil production separately were not available for 2009.
[xix] West Virginia Oil and Natural Gas Association, *Gas Facts, 2010 Edition*.
[xx] Louisiana Department of Natural Resources, "Louisiana State Mineral Severance Tax Revenue (excluding OCS)" (excludes offshore drilling proceeds), Updated April 11, 2011, http://dnr.louisiana.gov/assets/TAD/data/facts_and_figures/table29.htm
[xxi] Only land and buildings are taxable for property tax purposes. Data for only gas drillers is not available.
[xxii] Calculated using taxable values of oil/gas property and tax rate listed in Louisiana Tax Commission, *Annual Report 2009* (local taxes), http://www.latax.state.la.us/Menu_AnnualReports/UploadedFiles/2009%20Annual%20Report.pdf.
[xxiii] Severance taxes on oil and gas are levied separately in West Virginia, but the Gas Facts 2010 report combined the two values.
[xxiv] This figure includes employee withholding of $12.4 million, which likely overstates the income taxes owed by the drillers for operating in the Marcellus Shale.