

New Alternative Minimum Tax on Corporations under Biden's Inflation Reduction Act and its Impact on Deductibility of Intangible Drilling Costs

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Background on IDCs

Since 1913, the income tax deduction for intangible drilling and development costs tax (“IDCs”) has been allowed as a mechanism to attract capital for the high-risk business of exploring for and developing oil and natural gas. Despite various changes in the tax law over the years, the IDC deduction has remained an important incentive for oil and natural gas exploration and development to this day.

One change to the tax law that limited the benefit of the IDC deduction has been the alternative minimum tax. Before 2017, the alternative minimum tax treated the IDC deduction as a tax preference and limited the tax benefit of the deduction. However, corporations could avoid the alternative minimum tax on IDCs by electing to deduct the IDCs ratably over 60 months from when the IDCs were paid or incurred. Section 59(e). Any portion of an IDC expense subject to this election was not treated as an item of tax preference. Section 59(e)(6).

In 2017, the corporate alternative minimum tax was repealed by the Trump era Tax Cuts and Jobs Act. Since then, corporations have not been subject to the alternative minimum tax. As a result, most corporations were able to deduct 100% of their intangible drilling and development costs in the year incurred under Section 263(c) which grant taxpayers the option of deducting IDCs as ordinary and necessary business expenses. Note that for tax purposes, integrated oil companies (any producer of crude oil other than an independent producer) are required to capitalize 30% of all IDC and amortize them over 60 months, beginning in the month in which those costs are paid or incurred. Sections 291(b)(1) and 291(b)(2).

Overview of Book Minimum Tax under the Inflation Reduction Act

The Inflation Reduction Act (“IRA”), passed by the Senate on August 7, 2022, by the House of Representatives on August 12, 2022 and signed into law by President Biden on August 16, 2022, includes a reintroduction of the alternative minimum tax with a twist. The centerpiece of the tax plan is the addition of a 15 percent minimum tax on financial statement income of corporations that have average applicable financial statement income over \$1 billion, effective for tax years beginning after December 31, 2022. Applicable corporations will be paying an additional amount of tax equal to the excess of (i) 15% of the corporation’s applicable financial statement income over (ii) its regular corporate tax for the year.

The twist with this “new” alternative minimum tax (“Book Minimum Tax”) is that the calculation is based upon financial accounting net income. The starting point of the calculation is a corporation’s average annual adjusted financial statement income based upon financial statements prepared in accordance with generally accepted accounting principles with certain adjustments. This is a departure from the previous calculation of the corporate alternative minimum tax prior to its 2017 repeal, where the starting point was taxable income.

A central target of the IRA Book Minimum Tax was eliminating accelerated depreciation deductions that had allowed corporations to deduct their costs for capital expenditures from their taxable income quicker than under financial accounting rules. For financial accounting purposes, companies that invest in new machinery or equipment are required to deduct the asset over its useful life. However, for tax purposes, companies could deduct these costs much faster.

As originally proposed, the Book Minimum Tax would not have allowed a corporation to reduce its adjusted financial statement income using accelerated depreciation deductions. Fortunately, last minute changes authored by Senator Sinema were incorporated into the law which now allows accelerated depreciation deductions in calculating financial statement income.

Mechanics of New Book Minimum Tax

The IRA imposes this new Book Minimum Tax on corporations equal to the excess of 15% of an applicable corporation's adjusted financial statement income over its regular tax. Section 55(a)(2).

An applicable corporation subject to Book Minimum Tax for a tax year is any corporation (other than an S corporation, regulated investment company or a real estate investment trust) which meets the average annual adjusted financial statement income test over any consecutive three-year period preceding the tax year at issue (the "Income Test"). Section 59(k)(1)(A).

A corporation meets the Income Test if its average annual adjusted financial statement income for the three-year period (determined without regard to loss carryovers) ending with the tax year exceeds \$1 billion. Section 59(k)(1)(B)(i). Special rules for corporations in existence for less than three years and short corporate tax years apply. Sections 59(k)(1)(E)(i)

and 59(k)(1)(E)(ii).

The \$1 billion Income Test is applied (i) by including the income of all corporations that are treated as a single employer under Section 52(a) (commonly controlled corporations) or Section 52(b) (commonly controlled entities) and including the income from all partnerships in which the corporation owns an interest. Section 59(k)(1)(D).

A credit against regular tax liability is available to taxpayers that have Book Minimum Tax liability for all prior years beginning after 2022. Generally, this credit can be applied up to the excess of the corporation's (1) regular tax liability over (2) 15% of applicable financial statement income in the tax year. In a fashion similar to the old corporate alternative minimum tax, this credit effectively makes the new corporate Book Minimum Tax a prepayment of regular tax liability. Section 53(e).

Treatment of IDC under Book Minimum Tax

GAAP rules apparently govern the expensing of IDCs under the Book Minimum Tax. While the IRA included modifications to financial statement income to allow accelerated depreciation in determining the Book Minimum Tax, no such modifications were included for IDC deductions. The Book Minimum Tax remains a substantial tax increase on corporate income as it hits several book-tax differences, including IDCs.

This conclusion is supported by the following:

1. The Book Minimum Tax rule for corporations creates a new Code Sec. 56A which defines financial statement income.
2. Section 56A contains modifications to financial statement income including one for accelerated depreciation. However, there is no reference to modifications of financial statement income allowing immediate expensing of IDCs.
3. For GAAP, IDCs are capitalized and depleted.

4. Section 56A does not include a reference to depletion in the modifications of financial statement income.
5. Since under Section 56A, depletion is not technically part of depreciation, the corporate minimum tax financial statement income would use book depletion.

In summary, it appears that under the Book Minimum Tax rules, applicable corporations will only be able to recover IDC costs through depletion deductions slowly over the GAAP life of the assets.

Practical Impact of Book Minimum Tax

The Joint Committee on Taxation, Proposed Book Minimum Tax analysis, July 28, 2022, estimates that about 150 taxpayers would be subject to the corporate minimum tax annually; estimated to be about 30% of existing Fortune 500 companies. This means the Book Minimum Tax has an incredibly narrow base making 150 companies responsible for raising \$313 billion of the anticipated \$450 billion required to cover decarbonization expenditures in the Act.

Without a technical correction to the IRA, those corporations subject to the Book Minimum Tax who are engaged in the oil and gas industry apparently will no longer be able to get the benefit of an immediate tax deduction for IDCs after 2022. As a result, the investment in drilling projects by these corporations may slow. Oil and gas companies that meet the Income Test will likely face a substantial tax increase on their corporate income as the Book Minimum Tax hits several book-tax differences, including the all-important IDC deduction.

In an attempt to avoid this result, the Petroleum Alliance is actively engaging in discussions with key members of Congress to include a technical correction to the IRA modifying financial statement income that will allow an immediate deduction for IDCs. Many applicable corporations will be

waiting for regulatory guidance to correlate financial statement (e.g., GAAP) and tax rules to see what if any other relief may be available. Such corporations may also be considering whether changes can be made to their financial reporting to reduce their Book Minimum Tax while still complying with GAAP.

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