STATE AND FEDERAL TAX INCENTIVES FOR COAL AND OIL

This memorandum provides information on the availability of state and federal tax incentives relating to coal and oil.

COAL SEVERANCE TAX

The coal severance tax is imposed on the act of removing coal from the earth pursuant to North Dakota Century Code (NDCC) Chapter 57-61. The tax is in lieu of both the sales and use taxes on coal and the property tax on minerals in the earth. The coal severance tax applies to all coal severed for sale or industrial purposes, except coal used for heating buildings in the state, coal used by the state or any political subdivision of the state, and coal used in agricultural processing facilities in the state or adjacent states. The tax is applied at a rate of 37.5 cents per ton. An additional 2 cents per ton tax is levied for the lignite research fund. A 50 percent reduction of the 37.5 cent tax is allowed for coal burned in a cogeneration facility designed to use renewable resources to generate 10 percent or more of its energy output. A county may grant a partial or complete exemption from the county's 70 percent portion of the 37.5 cent tax for coal that is shipped out of state.

COAL CONVERSION PRIVILEGE TAX

The coal conversion tax is imposed in lieu of property taxes on the operator of each coal conversion facility pursuant to NDCC Chapter 57-60. The land on which the facility is located remains subject to property taxes. The privilege tax on coal conversion facilities is applied based on the type of coal conversion facility as follows:

- **Electrical generating plants** - Electrical generating plants are subject to two separate levies. One levy is a .65 mill times 60 percent of installed capacity times the number of hours in the taxable period, and the other levy is .25 mill per kilowatt-hour of electricity produced for sale. Installed capacity means the number of kilowatts a power unit can produce as displayed on the nameplate assigned to the turbine of the power unit.
- **Other coal conversion plants:**

  Coal gasification plants - A coal gasification plant is subject to a monthly tax in the amount of 13.5 cents per thousand cubic feet of synthetic natural gas produced for sale or 4.1 percent of gross receipts, whichever is greater.

  Plants converting coal to products other than gas - These plants are taxed at a rate of 4.1 percent of gross receipts.

  Coal beneficiation plants - The tax rate for a coal beneficiation plant is 20 cents per ton of beneficiated coal produced for sale or 1.25 percent of gross receipts, whichever is greater.

Exemptions to the coal conversion tax are:

- Synthetic natural gas produced in excess of 110 million cubic feet per day.
- Income from byproducts of a coal gasification plant to a maximum of 20 percent of gross receipts.
- Revenue derived from the sale and transportation of carbon dioxide for use in the enhanced recovery of oil or natural gas.
- Beneficiated coal produced in excess of 80 percent of a plant's design capacity or produced for use within a coal conversion facility.
- A new or repowered coal-burning electrical generation plant is exempt from the general fund portion of both levies for 5 years. The county may grant an exemption for up to 5 years from the county's 15 percent share of the levy on installed capacity.
- All new coal conversion plants other than electrical generating plants are exempt from the general fund's 85 percent share of the tax for 5 years. The county may grant a partial or complete exemption from the county's 15 percent share for up to 5 years.
- A coal conversion facility that achieves a 20 percent capture of carbon dioxide emissions during a taxable period receives a 20 percent reduction in the general fund share of the tax, and an additional reduction of 1 percent for every additional 2 percentage points of carbon dioxide emissions captured, up to a 50 percent reduction for 80 percent or more capture. The reduction is available for 10 years from the date of the first capture or from the date the facility is eligible to receive the credit.

Additional state tax incentives pertaining to coal include:

- A sales and use tax exemption for machinery or equipment used to produce coal from a new mine. The exemption for each mine is limited to the first $5 million of sales and use tax paid pursuant to NDCC Section 57-39.2-04.8.
- A sales tax exemption for materials used to construct or expand a facility used to extract or process byproducts associated with coal gasification pursuant to NDCC Section 57-39.2-04.11.
- A sales and use tax exemption for materials used to construct, expand, repower, or add environmental upgrades to an electrical generation plant, and all additions thereto, which processes or converts coal into electrical power pursuant to NDCC Sections 57-39.2-04.2 and 57-40.2-04.2.
- A sales and use tax exemption on gross receipts from the initial sale of beneficiated coal and the sale of coal that is exempt from the coal severance tax pursuant to NDCC Sections 57-39.2-04 and 57-40.2-04.
- A property tax exemption for each coal conversion facility and any carbon dioxide capture system located at a coal conversion facility pursuant to NDCC Section 57-60-06. The property tax exemption does not apply to the land on which the facility or capture system is located.

FEDERAL TAX INCENTIVES - COAL

Federal tax incentives pertaining to coal include:

- **Percentage depletion for hard mineral fossil fuels** - Pursuant to Sections 611 through 613A and 291 of the Internal Revenue Code, percentage depletion is available for coal and lignite at a rate of 10 percent of gross income from the property. The deduction is limited to 50 percent of taxable income from the property. For corporations, the percentage depletion for coal and lignite is reduced by an amount equal to 20 percent of the percentage depletion that exceeds the adjusted basis of the property.
- **Expensing of exploration and development costs for hard mineral fuels** - Pursuant to Sections 617(a) and 291 of the Internal Revenue Code, a mining company may elect to deduct 70 percent of the cost of domestic exploration and development. The remaining 30 percent of expenses must be capitalized and amortized over a 60-month period. Pursuant to Section 59(e) of the Internal Revenue Code, a taxpayer may elect to capitalize mine exploration and development expenses and amortize those expenses over a 10-year period.
- **Capital gains treatment of coal royalties** - Pursuant to Section 631(c) of the Internal Revenue Code, a taxpayer that owned minerals in place for at least 1 year before the minerals were mined may treat the royalties from the mined coal as long-term capital gains rather than ordinary income.
- **Advanced coal project credits** - Pursuant to Section 48A of the Internal Revenue Code, tax credits equal to 30 percent of qualified investments are allocated to projects that use integrated gasification combined cycle or other advanced coal-based electricity generation technologies to capture and sequester 65 percent of carbon dioxide emissions.
- **Gasification credit** - Pursuant to Section 48B of the Internal Revenue Code, tax credits equal to 30 percent of qualified investments are allocated to gasification projects that capture and sequester at least 74 percent of carbon dioxide emissions.
- **Carbon dioxide sequestration credit** - Pursuant to Section 45Q of the Internal Revenue Code, a credit is available for the sequestration of carbon dioxide captured from industrial sources. The credit is equal to $10 per metric ton, adjusted for inflation, for carbon dioxide used as a tertiary injectant in a qualified enhanced oil or natural gas recovery project. The credit is equal to $20 per metric ton, adjusted for inflation, for carbon dioxide permanently sequestered without first being used as a tertiary injectant.

OIL AND GAS GROSS PRODUCTION TAX

Pursuant to NDCC Chapter 57-51, a gross production tax of 5 percent of the gross value at the well is levied upon all oil produced in the state except a royalty interest in oil produced from an interest held by an organized Indian tribe or produced from a state, federal, or municipal holding. A gross production tax is levied upon all gas produced in the state and is calculated by taking taxable production times an annually adjusted flat rate per thousand cubic feet.

Exemptions from the gross production tax include:

- Gas used on the lease for production purposes and any royalty interest from gas produced from a state, federal, or municipal holding or from an interest held by an organized Indian tribe.
- Shallow gas produced during the first 24 months of production following the date gas was first sold from a shallow gas well and gas produced from a shallow gas well during testing, but prior to well completion, or during connection to a pipeline pursuant to NDCC Section 57-51-02.4.
- Gas burned at the well site to power an electrical generator that consumes at least 75 percent of the gas from the well pursuant to NDCC Section 57-51-02.5.
- Gas collected at the well site by a system that intakes at least 75 percent of the gas and natural gas liquids volume from the well for beneficial consumption pursuant to NDCC Section 57-51-02.6.

OIL EXTRACTION TAX

The oil extraction tax is levied on the extraction of oil from the earth pursuant to NDCC Chapter 57-51.1. As originally enacted, the tax rate was established at 6.5 percent of the gross value of oil at the well, subject to full or partial exemptions.

Legislation passed during the 2015 legislative session resulted in a significant restructuring of oil extraction tax rates and exemptions. The oil extraction tax rate was reduced from 6.5 to 5 percent, beginning January 1, 2016, and is subject to change depending on the average price of a barrel of crude oil. If the average price of a barrel of crude oil exceeds the trigger price of $90 for 3 consecutive months, the rate increases to 6 percent on all oil extracted. The rate remains at 6 percent until the average price of a barrel of crude oil falls below the trigger price of $90 for 3 consecutive months, at which time the rate reverts to 5 percent on all oil extracted.

The 2015 bill eliminated various exemptions that were dependent on the average monthly comparison price of a barrel of oil dropping below the trigger price in existence before 2016 for 5 consecutive months including:

- A 15-month exemption on the initial production from a vertical well;
- A 24-month exemption on the initial production from a horizontal well;
- An exemption on all oil recovered during the testing period before well completion;
- A 12-month exemption on production from a qualifying well that was worked over;
- A 10-year exemption on production from a certified 2-year inactive well; and
- A 9-month exemption on production from a certified horizontal re-entry well.

A 60-month exemption on the initial production from wells drilled and completed before July 1, 2013, on nontrust lands within the boundaries of an Indian reservation or on lands held in trust by the United States for an individual Indian or tribe, and wells drilled and completed before July 1, 2013, on lands held by an Indian tribe if the interest was in existence on August 1, 1997, was also eliminated after December 31, 2015. A 24-month exemption from oil extraction tax for wells drilled and completed as a horizontal well when the prior triggered rate exemptions were in effect was eliminated on December 1, 2015, as was a reduced tax rate of 4 percent on oil produced from new wells, drilled and completed after April 21, 1987.

Rate reductions eliminated after December 31, 2015, included rate reductions dependent on the average monthly comparison price of a barrel of oil dropping below the trigger price in existence before 2016 for 5 consecutive months. The eliminated reductions previously lowered the 6.5 percent tax rate to 4 percent on:

- Oil produced from a vertical well completed after April 27, 1987, following the first 15 months of exempt production;
- Oil produced from a horizontal well completed after April 27, 1987, following the first 24 months of exempt production;
- Oil produced from a qualifying secondary or tertiary recovery project certified by the Industrial Commission after June 30, 1991; and
- Incremental oil produced from a qualifying secondary or tertiary recovery project, following the initial 5-year or 10-year exemption period.

In addition, production on which a rate reduction was dependent on the average price of a barrel of oil falling below $55 for 1 month was eliminated after December 31, 2015. The reduction previously lowered the 6.5 percent tax rate to 2 percent on the first 75,000 barrels, or the first $4.5 million of gross value at the well, whichever was less, of oil produced during the first 18 months after completion. The rate reduction applied only to horizontal wells drilled and completed after April 30, 2009, and before July 1, 2015.

Production that remains exempt from the oil extraction tax after December 31, 2015, includes:

- Liquids produced from a collection system employed to avoid flaring, which are exempt for a period of 2 years and 30 days from the time of first production;
- Production that is exempt from the gross production tax imposed by NDCC Chapter 57-51;
- Production from stripper well property or an individual stripper well;
- Incremental production from a secondary recovery project for 5 years from the date incremental production begins;
- Incremental production from a tertiary recovery project for 10 years from the date incremental production begins; and
- Incremental production from a tertiary recovery project for 5 years from the date incremental production begins if the project is located outside the Bakken and Three Forks Formations.

Incremental production from a tertiary recovery project from a horizontal well drilled and completed within the Bakken and Three Forks Formations is not exempt from oil extraction tax from July 1, 2015, through June 30, 2017, but is thereafter exempt for a period of 5 years from July 1, 2017, or the date incremental production begins, whichever is later.

Production that continues to be subject to a reduced oil extraction tax rate after December 31, 2015, includes production from wells drilled and completed outside the Bakken and Three Forks Formations and 10 miles or more outside an established field that includes either formation. The first 75,000 barrels of oil produced during the first 18 months after completion are subject to a reduced tax rate of 2 percent on the gross value at the well of oil extracted.

Additional tax incentives pertaining to oil and gas include:

- A sales and use tax exemption for materials used to reduce emissions, increase efficiency, or enhance the reliability of equipment at a new or existing oil refinery or gas processing plant pursuant to NDCC Sections 57-39.2-04.2 and 57-40.2-04.2.
- A sales and use tax exemption for gross receipts from sales of carbon dioxide used for enhanced recovery of oil or natural gas pursuant to NDCC Sections 57-39.2-04 and 57-40.2-04.
- A sales tax exemption for gross receipts from sales of natural gas or sales of fuels used for heating purposes pursuant to NDCC Section 57-39.2-04.
- A sales and use tax exemption for materials used to construct or expand a system used to compress, process, gather, collect, or refine gas recovered from an oil or gas well in this state or used to expand or build a gas processing facility in this state pursuant to NDCC Sections 57-39.2-04.5 and 57-40.2-03.3.
- A sales and use tax exemption for materials used to expand or construct an oil refinery that has a nameplate capacity of processing at least 5,000 barrels of oil per day pursuant to NDCC Sections 57-39.2-04.6 and 57-40.2-03.3.
- A sales and use tax exemption for materials used to construct or expand a processing facility to produce liquefied natural gas pursuant to NDCC Sections 57-39.2-04.10 and 57-40.2-03.3.
- A sales tax exemption for materials used to construct or expand a system used to compress, gather, collect, store, transport, or inject carbon dioxide for use in enhanced recovery of oil or natural gas pursuant to NDCC Sections 57-39.2-04.14 and 57-40.2-03.3.
- A property tax exemption for equipment, machinery, tools, materials, and property necessary, and actually being used at the site of a producing well, for the production of oil and gas pursuant to NDCC Section 57-51-04. The property tax exemption expressly does not apply to drilling rigs, gasoline extraction or absorption plants, water systems, fuel systems, hospitals, residences, and various other buildings.

- A property tax exemption for any equipment directly used for enhanced recovery of oil or natural gas pursuant to NDCC Section 57-60-06. The property tax exemption does not apply to the land on which the equipment is located.
- A property tax exemption for property, exclusive of land, and necessary associated equipment for the transportation or storage of carbon dioxide for use in enhanced recovery of oil or natural gas pursuant to NDCC Section 57-06-17.1. The property tax exemption applies for the first 10 full taxable years following the initial operation of the pipeline, but does not apply to the land on which the property and associated equipment is located.

FEDERAL TAX INCENTIVES - OIL AND GAS

Federal tax incentives pertaining to oil and gas include:

- **Expensing of intangible drilling costs** - Pursuant to Sections 263(c) and 291 of the Internal Revenue Code, taxpayers may elect to expense, rather than capitalize, intangible drilling costs paid or incurred in the development of oil or natural gas property.
- **Cost and percentage depletion for oil and natural gas wells** - Pursuant to Sections 611 through 613A and 291 of the Internal Revenue Code, taxpayers with an economic interest in a producing mine or oil and gas property may elect to use cost depletion or percentage depletion. Cost depletion is limited to the taxpayer's basis in the property. Percentage depletion is subject to limitations based on the net income derived from the property and taxable income. Percentage depletion is available only to independent producers and royalty owners. Integrated oil and gas companies must use cost depletion.
- **2-year amortization period for geological and geophysical expenditures** - Pursuant to Section 167(h) of the Internal Revenue Code, independent producers of oil and natural gas may amortize geological and geophysical expenditures over a 2-year period.
- **Deduction for tertiary injectants** - Pursuant to Section 193 of the Internal Revenue Code, a taxpayer engaged in petroleum extraction activities may deduct, rather than capitalize, qualified tertiary injectant expenses incurred in the recovery of crude oil.
- **Exception to passive loss limitation for working interests in oil and natural gas properties** - Pursuant to Section 469 of the Internal Revenue Code, a taxpayer that owns a working interest in a manner that does not limit the taxpayer's liability may offset active income with losses from the working interest in the oil and gas property.
- **Enhanced oil recovery credit** - Pursuant to Section 43 of the Internal Revenue Code, a taxpayer is allowed a 15 percent credit for expenses associated with an enhanced oil recovery project using one or more tertiary recovery methods. The credit phases out if the crude oil reference price in the prior taxable year exceeds $28 per barrel, indexed for inflation, by at least $6.
- **Marginal well credit** - Pursuant to Section 45I of the Internal Revenue Code, a $3 credit per barrel, adjusted for inflation, applies to production of crude oil from a marginal well. A 50 cent credit per thousand cubic feet, adjusted for inflation, applies to production of natural gas from a marginal well. Marginal wells are defined as wells with an average daily production of no more than 25 barrels per day.
- **Carbon dioxide sequestration credit** - Pursuant to Section 45Q of the Internal Revenue Code, a credit is available for the sequestration of carbon dioxide captured from an industrial source. The credit is equal to $10 per metric ton, adjusted for inflation, for carbon dioxide used as a tertiary injectant in a qualified enhanced oil or natural gas recovery project. The credit is equal to $20 per metric ton, adjusted for inflation, for carbon dioxide permanently sequestered without first being used as a tertiary injectant.