

GAO

Report to the Joint Committee on
Taxation
Congress of the United States

April 1986

TAX POLICY

**Investment Tax Credit
for Offshore Drilling
Rigs Needs
Clarification**



035235



United States
General Accounting Office
Washington, D.C. 20548

General Government Division

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The Honorable Bob Packwood
Chairman, Joint Committee on
Taxation

The Honorable Dan Rostenkowski
Vice Chairman, Joint Committee on
Taxation
Congress of the United States

As you know, the Congress is currently considering possible repeal of the investment tax credit in the context of general tax reform. If repeal of the credit does not occur, the Congress should consider clarifying the circumstances under which the credit is to be allowed for offshore drilling rigs used in foreign waters.¹

Historically, property used predominantly outside the United States has not been eligible for the investment tax credit unless a specific "foreign-use" exception applied. However, congressional intent regarding the scope of the allowance of the investment tax credit for offshore drilling rigs used in foreign waters is not clear. In the Tax Reduction Act of 1975, the Conference Report stated that Congress intended to limit the credit to only those offshore rigs used in the northern portion of the Western Hemisphere.² However, when enacting this restriction, Congress apparently was unaware of the IRS' longstanding ruling policy under a foreign-use exception that was not amended by the 1975 act—section 48(a)(2)(B)(iii). Under this section, IRS allowed, and continues to allow, the investment tax credit for certain offshore rigs used anywhere in the world. We estimate that at least \$344 million of investment tax credit have been available since 1975 for offshore drilling rigs used outside the northern portion of the Western Hemisphere.³

¹While this report deals specifically with the investment tax credit, we note that the cost of foreign-use property not qualifying for a foreign-use exception is subject to depreciation rates that may be less beneficial than those generally available for property used within the United States. Under the House-passed tax reform bill (H.R. 3838), foreign-use property not qualifying for a specific foreign-use exception will continue to be subject to special depreciation rates. Thus, the scope of the foreign-use exceptions discussed in this report could remain relevant for depreciation purposes even if the investment tax credit is repealed.

²See appendix II for a map and description of the prescribed area.

³In addition to the investment tax credit, there may have been further revenue loss due to the depreciation provisions. We did not calculate this possible loss because the necessary data was not readily available.

This report presents (1) information on the history of the investment tax credit and the applicable exceptions for offshore drilling rigs, (2) IRS' basis for allowing the credit for such rigs, and (3) estimates of the dollar amounts of credit that have been available for offshore drilling rigs placed in service after 1975 and used outside the designated portion of the Western Hemisphere.

Appendix I presents a detailed statement of our objectives, scope, and methodology. Our work was performed during the period from January through December 1985 in accordance with generally accepted government auditing standards.

History of the Investment Tax Credit

The investment tax credit was added by the Revenue Act of 1962 (Pub. L. No. 87-834) in response to Congress' perceived need to provide an additional incentive for expansion and modernization of capital equipment to improve the United States' competitive position abroad and to aid in meeting the nation's balance of payments. The investment tax credit generally allows taxpayers to reduce their federal income tax liability on a dollar-for-dollar basis by the amount of the credit taken. The amount of the credit is generally determined by multiplying the cost of the property eligible for the credit by a specified percentage, currently up to 10 percent.

Since its enactment in 1962, the rate of the credit and limitations on its use have undergone several changes; indeed, the credit was suspended from October 1966 to March 1967, repealed in April 1969, and restored in August 1971. In 1985, the House of Representatives passed a tax reform bill (H.R. 3838), which, if enacted, would repeal the investment tax credit. At the time our study was completed, this bill had not been considered by the Senate; thus, the continued availability of the credit was uncertain.

Limitations on the Credit for Property Used Outside the United States

The investment tax credit is designed, in part, to promote capital formation within the United States. Both domestically and foreign-built equipment are eligible for the investment tax credit if the equipment is used in the United States. Property used predominantly outside the United States is not eligible for the credit unless a specific "foreign-use" exception applies.

The Revenue Act of 1962 included six such exceptions allowing the investment tax credit for property used predominantly outside the

United States. One of these foreign-use exceptions was for certain U.S.-owned property used for exploring, developing, removing, or transporting natural resources from the Outer Continental Shelf of the United States.⁴ According to the technical explanation of the 1962 act, this exception was intended to allow the credit for offshore drilling rigs.

The Revenue Act of 1971 (Pub. L. No. 92-178) added another exception—section 48(a)(2)(B)(x)—which, in effect, expanded the Outer Continental Shelf exception. This provision allowed an investment tax credit for certain U.S.-owned property used in any international or territorial waters for exploring, developing, removing, or transporting natural resources. According to the Senate Finance Committee report, this provision was included because a substantial amount of offshore drilling activity was expected to take place in foreign waters and, accordingly, a tax code amendment was needed to allow the investment tax credit for U.S.-owned offshore drilling rigs engaged in foreign drilling operations.

Four years later, the Tax Reduction Act of 1975 (Pub. L. No. 94-12) amended section 48(a)(2)(B)(x) by restricting the exception to property used only within the northern portion of the Western Hemisphere (see map at app. II). The legislative history of the amendment provides little explanation for why the exception was limited to this geographic area. However, the Conference Report of the 1975 act stated that the amendment “denies the investment tax credit for foreign situs drilling rigs used outside the northern half of the Western Hemisphere.”

IRS Allows the Credit for Offshore Rigs Without Consideration of Geographic Location

Notwithstanding the 1975 restriction, IRS continues to permit offshore drilling rigs operating outside the northern portion of the Western Hemisphere to qualify for the investment tax credit under another foreign-use exception—section 48(a)(2)(B)(iii)—which was included in the 1962 act and which has not since been amended. The legislative history of this act does not indicate the purpose for this exception. Generally, under this exception any vessel documented under the laws of the United States which is operated in the foreign or domestic commerce of the United States qualifies for the credit.⁵

⁴Section 48(a)(2)(B)(vi).

⁵The applicable income tax regulations provide that a vessel is documented under the laws of the United States if it is registered, enrolled, or licensed by the U.S. Coast Guard. Generally, documentation allows (but does not require) a vessel to engage in foreign trade and permits the vessel to fly the U.S. flag. Under Coast Guard criteria, certain offshore drilling rigs are eligible for documentation.

In 1969, IRS issued a revenue ruling stating that a vessel documented by the U.S. Coast Guard qualifies for the investment tax credit under section 48(a)(2)(B)(iii).⁶ Based generally on this ruling, IRS allows the credit on any offshore drilling rig documented by the Coast Guard and has issued numerous private letter rulings and technical advice memoranda to this effect.

Following the Tax Reduction Act of 1975, IRS thought there might be a need for legislative clarification. For example, in 1981, IRS' Legislative Analysis Division drafted a legislative recommendation that would have specifically denied the investment tax credit for offshore drilling rigs used outside the northern portion of the Western Hemisphere. The explanation accompanying the legislative recommendation stated, in part, that

"... While the statutory language and the related legislative history... [have] been ambiguous, there is some indication that Congress apparently intended to deny the investment credit to drilling rigs that are... used abroad. Possibly because Congress did not understand the Service's ruling policy of long standing, the modification of section 48(a)(2)(B)(x) by the Tax Reduction Act of 1975 failed to achieve what appears to have been its intended purpose. [This legislative]... proposal would deny the investment credit for oil and gas drilling rigs documented as vessels, but would continue to permit the credit to the extent that these rigs are used in the northern portion of the Western Hemisphere... Both the Regional Commissioner (Southwest Region) and the Assistant Commissioner (Technical) support this legislative change."

In 1983, IRS' Chief Counsel decided to hold this proposal because of more pressing issues. IRS never formally submitted its recommendation to Treasury.

Amount of Credit Available on Offshore Rigs Is Substantial

Since 1975, the amount of investment tax credit available on documented offshore drilling rigs used outside the northern portion of the Western Hemisphere has been substantial. We identified 94 such U.S.-owned rigs that were placed in service as new property during the period 1976 through 1985. We estimate that from \$344 to \$375 million of investment tax credit was available on these 94 rigs.⁷ We did not estimate how much of this amount was or will be used because the necessary taxpayer information was not readily available for each year the credits may have been claimed. For example, if investment tax credits

⁶Rev. Rul. 69-509, 1969-2 C.B. 3.

⁷Of these 94 rigs, 64 were constructed outside of the United States.

are not used in the year new property is placed in service they may be carried back to prior tax years and forward to subsequent tax years. Currently, the carryback period is 3 years, and the carryforward period is 15 years.

As table 1 shows, in addition to the 94 rigs already in use, we identified, as of December 1985, 16 other offshore rigs under contract for construction for U.S. companies for delivery in 1986 and future years.⁸ With an average cost of about \$70 million each, we estimate that the investment credit available on these 16 rigs could range from \$90 million to \$112 million.

We do not know where these 16 rigs will be used. However, some industry literature suggests that the best prospects for increased offshore drilling are generally located outside the northern portion of the Western Hemisphere. For example, according to the December 1985 issue of Ocean Industry magazine, the best prospects for increases in offshore drilling over the next 12 months are in the areas of Australia, China, Europe, Egypt, the Gulf of Mexico, and India. Except for the Gulf of Mexico, all of these areas are located outside the northern portion of the Western Hemisphere.

⁸Of these 16 rigs, 14 are being constructed in foreign shipyards.

Table 1: Estimated Amounts of Investment Tax Credit Available on Documented Offshore Drilling Rigs Placed in Service After 1975 and Used Outside the Northern Portion of the Western Hemisphere (Dollars in Millions)

Calendar year placed in service	Number of U.S.-owned rigs			Rig costs ^a		Investment credit amounts ^b	
	Foreign built	Domestic built	Total	Average	Total	8 percent	10 percent
1976	2	3	5	\$32	\$ 160	\$	\$ 12
1977	4	3	7	40	279		24
1978	3	1	4	22	87		8
1979	2	3	5	24	121		9
1980	5	2	7	24	171		16
1981	10	10	20	33	663		65
1982	16	6	22	40	875		87
1983	17	2	19	56	1,069	86	107
1984	4	0	4	98	391	31	39
1985	1	0	1	75	75	6	8
Subtotals	64	30	94		\$3,891	\$344^c	\$375
Under contract in 1985	14	2	16	70	1,119	90	112
Totals	78	32	110		\$5,010	\$434	\$487
	71%	29%	100%				

^aDue to rounding, total rig costs do not always equal average costs times the number of rigs.

^bGenerally, for the period 1976 through 1982, the amount of investment tax credit was 10 percent of the cost of the property. However, for property placed in service after 1982, owners have had an option; they can either take a 10 percent credit and reduce the depreciable basis of the property by 50 percent of the credit, or take an 8 percent credit with no basis reduction. The option chosen by a taxpayer depends on the taxpayer's tax situation. We estimated the amount of available investment tax credit by first multiplying the total rig cost by 10 percent and, after 1982 by 8 percent to reflect the taxpayer's option. With respect to those rigs that were initially placed in service within the northern portion of the Western Hemisphere, but subsequently removed from this area, we then adjusted the resulting amounts to account for the credits that would have been subject to recapture under Internal Revenue Code section 47. Therefore, the estimated amounts of investment tax credit do not always equal total rig costs times the applicable investment tax credit percentage.

^cThis amount includes \$221 million of investment tax credit for the period 1976 through 1981.

Source: Developed by GAO staff using data from the U.S. Coast Guard, IRS, and industry (see app. I for more details about methodology).

Conclusion

Congressional intent regarding the scope of the allowance of the investment tax credit for offshore drilling rigs used in foreign waters is not clear. In the Tax Reduction Act of 1975, the Conference Report stated that Congress intended to limit the credit to only those offshore rigs used in the northern portion of the Western Hemisphere. However, when enacting this restriction, Congress apparently was unaware of the IRS' longstanding ruling policy under a foreign-use exception that was not amended by the 1975 act—section 48(a)(2)(B)(iii). Under this section, IRS allowed, and continues to allow, the investment tax credit for

certain offshore rigs used anywhere in the world. Therefore, significant tax revenue could have been lost, and additional revenue may be foregone unless Congress clarifies the law.

**Matter for
Consideration by the
Congress**

If the investment credit is not repealed, the Congress should consider clarifying the circumstances under which the investment tax credit is allowed for offshore drilling rigs used outside the northern portion of the Western Hemisphere.

Agency Comments

The Department of Treasury orally informed us that it had no comments on the report. IRS orally pointed out that the foreign use exceptions may have continuing applicability for depreciation purposes (see footnote 1).

We are sending copies of this report to the Senate and House Committees on Appropriations; the Senate and House Committees on the Budget; the Director, Office of Management and Budget; the Secretary of the Treasury; and other interested parties.

W. J. Anderson

William J. Anderson
Director

Objectives, Scope and Methodology

In view of current congressional interest in the investment tax credit and the uncertainty surrounding congressional intent regarding the availability of the credit for offshore drilling rigs operating in foreign waters, we initiated this study to

- analyze the congressional intent of legislation allowing the investment tax credit for foreign-use offshore rigs,
- ascertain why IRS allows an investment tax credit for offshore drilling rigs used outside the northern portion of the Western Hemisphere, and
- estimate the amount of investment tax credit available with respect to offshore drilling rigs placed in service after 1975 and used outside the northern portion of the Western Hemisphere.

To determine congressional intent regarding allowability of the investment tax credit for offshore drilling rigs, we reviewed the legislative history of the relevant public laws—the Revenue Act of 1962, the Revenue Act of 1971, and the Tax Reduction Act of 1975. We also discussed these acts with officials of IRS' Office of Chief Counsel and the Legislative Analysis Division.

To determine why IRS allows the investment tax credit for offshore drilling rigs operating outside the northern portion of the Western Hemisphere, we reviewed IRS' regulations, revenue rulings, private letter rulings, and technical advice memoranda. In addition, we reviewed IRS correspondence, including legal memoranda, on the issue. We also discussed the availability of the investment tax credit for foreign-use rigs with the Department of the Treasury's International Tax Counsel and with IRS officials in the Office of Chief Counsel; the Legislative Analysis Division; the Southwest regional office; and the district offices in Dallas and Houston, Texas; New Orleans, Louisiana; and Oklahoma City, Oklahoma. We selected these IRS offices because they deal frequently with oil industry issues.

We also determined the basis upon which the U.S. Coast Guard documents vessels, including drilling rigs, for use in the foreign or domestic commerce of the United States. We reviewed Coast Guard regulations and legal memoranda, and interviewed U.S. Coast Guard officials.

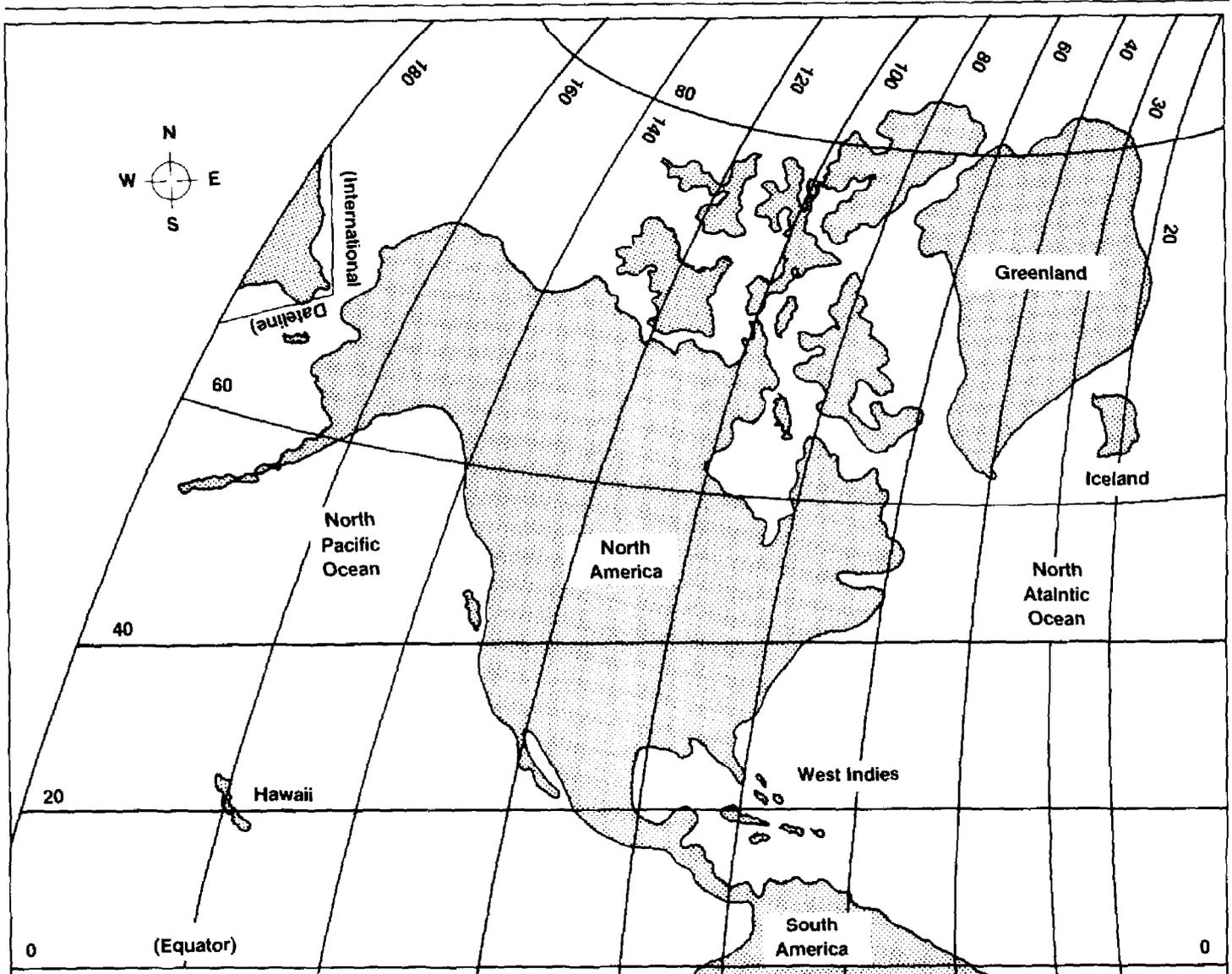
To estimate the amounts of investment tax credit available with respect to documented offshore drilling rigs placed in service after 1975 and

used outside the northern portion of the Western Hemisphere, we used both government and industry sources of information. For example, we

- identified U.S.-owned rigs placed in service during 1976-1985 and rigs contracted for construction completion and delivery in 1986 and future years from records provided by the U.S. Coast Guard;
- traced when and where these rigs were operated by reviewing 1976 through 1985 editions of Petroleum Engineer International magazine, published by Energy Publications, Dallas, Texas, which presents offshore rig locator information; and
- obtained rig construction costs from various sources, including (1) audit workpapers in IRS district offices and (2) Offshore Data Services, Inc., a Houston, Texas, company that publishes offshore rig information.

After obtaining this information, we estimated the amounts of investment tax credit presented in table 1. Our methodology in making these estimates is explained in the table footnotes.

Map of the Northern Portion of the Western Hemisphere



Description of Area: Internal Revenue Code section 48(a)(2)(B) describes the northern portion of the Western Hemisphere as "the area lying west of the 30th meridian west of Greenwich, east of the international dateline, and north of the Equator, but not including any foreign country which is a country of South America."

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