



2010 Oil and Gas Income Tax Considerations for Farm and Forestlands

Developed by

Curtis Talley Jr.

District Farm Management Educator

Michigan State University Extension

Hart, Michigan 49420

talleycu@msu.edu

This information has been reviewed by the Oil & Gas industry team at the CPA firm of Dennis, Gartland & Niergarth, Traverse City, MI. For more information, contact Michael D. Shaw, CPA at 231-946-1722 or mshaw@dgn CPA.com or visit www.dgn CPA.com

August, 2010

BACKGROUND

There is a significant volume of oil and gas leasing activity occurring throughout most of the State of Michigan. Farmers and Landowners may be receiving income from sources not normally associated with agricultural or forestry operations such as leasing bonuses, royalties, rights-of-way, surface damages and delay rentals. They have asked for information to assist in income tax planning. The chart below indicates the different types of payments that landowners may earn and how those payments will be categorized according to IRS regulations.

Type of Income	Farmer Taxable Status	S.E. Tax**	Timber Owner Taxable Status	S.E.Tax**
Delay rental	Ordinary income	No	Ordinary income	No
Shut in payments	Ordinary income	No	Ordinary income	No
Bonus	Ordinary income	No	Ordinary income	No
Royalty payments	Ordinary income	No	Ordinary income	No
Crop damages	Ordinary income	Yes	Reduction to basis*	No
Surface damages	Ordinary Income	No	Reduction to basis*	No
Right of Way	***	No	***	No

*If the payment exceeds the landowner’s basis in the property, the excess is taxed at capital gain rates

** Subject to self employment (12.4% for social security and 2.9% for Medicare for a total of 15.3%)

*** See right-of way discussion

INCOME

There are two types of income, ordinary income and capital gains. Ordinary income is composed mainly of wages, salaries, farm and business profits, dividends from stock shares, commissions and interest income. Capital gains income generally comes from the sale of land or other investment property. It is considered as either a short term or long term gain or loss. If the asset is held less than 366 days prior to sale, the gain or loss is considered short term and the income tax rate is the same as ordinary income tax rates. If the asset is held greater than one year, upon sale, any gain or loss is considered long term and taxed at lower rates. For 2010, long term capital gains tax rates are 0% if taxable income is less than \$68,000 and generally 15% for income exceeding \$68,000, if married and filing jointly.

As the chart on page one demonstrates, most of the income related to oil and gas exploration is considered ordinary income. Many of the payments are not subject to self employment (social security and Medicare) taxes, because they are not considered earned income.

CROP AND SURFACE DAMAGES

Anticipatory surface damages, where the company pays the surface owner and labels it as damages, but no damages actually occur are treated as ordinary rental income, but not subject to self employment tax. Payments for actual damages to crops substitute for the eventual sale of the crop, are ordinary income and subject to self employment taxes being owed.

REDUCTIONS TO INCOME

In the case of oil and gas royalties, income can be reduced for federal income tax purposes by the depletion deduction.

DEPLETION

Depletion is the using up of natural resources by mining, quarrying, drilling, or felling. The depletion deduction allows a royalty owner to account for the reduction of a product's reserves.

There are two ways of figuring depletion: cost depletion and percentage depletion. For mineral property, you generally must use the method that gives you the larger deduction.

Percentage depletion is a flat rate of 15% of the gross oil and gas income. The percentage depletion allowance is limited to 65 percent of taxable income for the year. For standing timber, you must use cost depletion. That calculation is not discussed here.

RIGHTS OF WAY

Income you receive for granting rights of way for laying pipelines, constructing roads, constructing electric or telephone lines, etc. may result in income, a reduction in basis on all or part of your property or both.

For example, you granted a right-of-way for a gas pipeline through your property for \$10,000. Only a specific part of your farmland was affected. You reserved the right to continue farming the surface land after the pipe was laid. Treat the payment for the right of way in one of the following ways:

1. If the payment is **less than** the basis (usually the purchase price) properly allocated to the part of our land affected by the right-of-way, reduce the basis by \$10,000. For example, if the affected acres were purchased for a total of \$15,000, the basis will be reduced to \$5,000 ($\$15,000 - \$10,000 = \$5,000$) and no income tax is owed.
2. If the payment is **equal to or more than** the basis of the affected part of your land, reduce the basis to zero and the rest, if any is capital gain from a sale. Let's take a new example. If there were 3 acres affected by a right of way and the properly allocated original purchase price was \$3,000/acre, the total purchase price (basis) was \$9,000. A right of way payment of \$15,000 was received. Allocate \$9,000 of the right-of-way payment to reduce basis and the remaining \$6,000 will be taxed at capital gains rates. At 2010 tax rates, if the property was owned at least 366 days, you are married and filing taxes jointly and your taxable income is less than \$68,000 there is no tax owed on the \$6,000. If your income is greater than \$68,000, say \$75,000, you would pay 15% tax on \$6,000, or \$900.
3. Right of way income may be considered ordinary rental income. For example, if a right of way is granted for the construction of a building that is expected to be present ten years and then removed and the land will revert to its original usage, the income could be ordinary rental income.

The right-of-way payment in each example is not subject to self employment tax (social security and Medicare).

INCOME AVERAGING

Income averaging is available for certain farm income. Some of the income from the chart on page one may be subject to income averaging for farms and timber. Income averaging is no longer available for any wage earners or small businesses, as it was repealed in the tax act of 1986.

SEVERANCE TAXES

The State of Michigan levies an oil and gas severance tax on royalty owners and oil and gas producers on the gross cash market sales value. The rate is 6.6% for oil, 5% for gas and 4% for stripper wells and marginal properties. There is also a .29% oil and gas fee imposed to cover the costs by the Supervisor of Wells in overseeing the development of oil and gas in the state. This fee is not to exceed 1% and is adjusted annually.

TIMBER CROP AND SURFACE DAMAGES

I will discuss two types of timber property; that purchased for investment and a timber tract that is part of a larger farm property and is not managed as a commercial forest.

If a timber property is held as an investment property, it is a capital asset. Payments received reduce the basis in the same manner as basis is reduced for the receipt of right of way payments.

Farmers who cut timber on their land and sell it as logs, firewood, or pulpwood usually have no cost or other basis for that timber. Amounts realized from these sales and the expenses incurred in cutting, hauling, etc., are ordinary farm income and expenses and are reported on Schedule F. For example, Farmer John has a 2 acre timbered area that must be cut down for an oil and gas well pad. The trees

were valued at a total of \$5,000 by a qualified forester and the cost to cut and haul the trees is \$2,000. Ordinary income of \$3,000 is earned. The oil and gas company may pay an additional \$3,000 as surface damages. This results in total ordinary income of \$6,000.

Oil and gas taxation is a very complex area and there may be exceptions to the information contained in this publication. We recommend you consult the Internal Revenue Service or a qualified tax professional to determine your tax liability for your specific situation.

Reference List: Internal Revenue Service. 2009. *Publication 535 Business Expenses*
Harris, Philip E., et.al. 2009 National Income Tax Workbook
Internal Reverse Service. 2009. *Publication 225 Farmers Tax Guide*

Michigan State University (MSU) is an affirmative-action, equal opportunity employer. MSU Extension programs and materials are open to all without regard to race, color, national origin, gender, gender identity, religion, age, height, weight, disability, political beliefs, sexual orientation, marital status, family status or veteran status.