

Are There Any Tax Goodies in the Oil Business?

By: Paul Mangum

In a word – yes. Tax incentives are widely available to oil and gas investors and operators. Some are well known, such as the deductions for intangible drilling and development costs (IDCs) and percentage depletion. Some are more obscure, such as the new deduction for production of natural gas and the credit for qualified marginal production, both introduced in 2004.

Before you invest you should investigate the possible tax benefits. Many people are surprised that the promised immediate benefit is not available due to the deal's structure or because of other seemingly unrelated elements of their tax return. "Now you tell me!"

The Big Daddy of benefits to oil and gas investors has always been completely writing off the up-front IDCs. Why is this a big deal? Well, let's say you are deciding between a real estate or an oil and gas investment. If you invest in the building, you will recover your investment through depreciation over the next 39 years. If you invest in an oil or gas well, the IDC portion can be completely deducted through depletion in year one. Maybe.

Whoa, there's a downside? Yep. As you may know, many losses are restricted by the "passive activity" rules. In very general terms, those rules specify that, to deduct net losses from a business, you have to materially and regularly participate in the business. You can't merely *invest* in the business and let somebody else run it.

Good news – there is a specific exception to these rules carved out for oil and gas: you don't have to materially participate to get your deduction. Bad news - to meet the exception, you can't invest with limits on your personal liability. So, if you are a limited partner you will be subject to the passive activity rules. If you have passive income already then you will get your deduction immediately, up to the amount of your passive income. If you don't, then you must wait until you have passive income or you sell the activity.

Even if you do get an immediate write off, you should know that alternative minimum tax (AMT) implications are involved. If you have high IDCs, then they may constitute a "preference" item for AMT purposes. We can tell you if the promised write-off is usable immediately and if it will expose you to AMT.

Next – let's consider the other special benefit available to oil and gas investments – percentage depletion. Depletion is an accounting convention very similar to depreciation – that is, it is a way to recover your investment in an asset through deductions over time. Oil and gas investors can take this deduction in one of two ways – cost or percentage depletion (whichever is greater). Cost depletion, like depreciation, is limited to the total cost you have in the asset. In oil and gas, this is the leasehold cost. Percentage depletion is 15% of your gross oil and gas revenues and is not limited by your leasehold cost. It can go on as long as the well produces. Now there's a benefit!

There are some restrictions on the availability of percentage depletion (of course). First, the property itself must be profitable. So, percentage depletion is not available if operating costs exceed revenues. Second, it may be limited by your taxable income (before the deduction for depletion). The good news is that if this occurs, the excess amount disallowed as a current deduction will carry over for use in the future. Remember, if you own your oil and gas interest as a limited partner, the depletion will be

subject to the passive activity rules mentioned above. Again, ask us if you will be eligible for the promised benefit.

Earlier I mentioned two new benefits. It appears that their impact will be fairly limited. We'll keep our eye on these and other potential new tax changes of importance to the oil and gas industry.

The message here is simple – there are some real tax benefits to oil and gas investing. Be aware, though, that if you are investing partly because of the tax benefits, you need to know the rules. We know the rules and can help answer your questions.