



FACT SHEET

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“Shale Oil and Gas Development” Fact Sheet Series

Income Tax Management of Oil and Gas Lease Payments

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Introduction

A renewed interest in oil and gas leasing in Ohio has the potential to provide landowners with substantial new revenue. Landowners who receive income from oil and gas lease bonus payments and royalty payments must understand the tax implications. Oil and gas income is subject to both federal and state income tax and must be reported appropriately. While a landowner can't avoid paying taxes on oil and gas revenues, the landowner can use strategies to manage income taxes. This fact sheet reviews how to report oil and gas revenues and summarizes examples of tax management strategies for landowners. This publication is not intended to provide individual legal or financial advice; we recommend the assistance of a qualified attorney and/or accountant.

Federal Taxation on Lease Bonus and Delay Rental Payments

Cash payments received by a landowner prior to drilling, commonly referred to as lease bonus payments, are considered ordinary income for tax reporting purposes and are subject to ordinary income taxes. These payments are typically paid on a per acre basis and are made either annually for each year of the lease's primary term or as a lump-sum payment that combines all annual payments into one payment (a “paid up” lease). All lease bonus payments are reported to landowners on IRS Form 1099 MISC, Box 1, Rents. Lease payments must be reported on page 1 of Schedule E, Supplemental Income and Loss. This amount then flows to line 17 of IRS Form 1040 and is not subject to self-employment tax. Some oil and gas lease agreements will refer to a “delay rental payment” that the developer will pay to extend the primary term and allow additional time to begin drilling activities. Delay rental payments are also considered ordinary income and should be reported in the same way as lease bonus payments.

Federal Taxation on Royalty Payments

If drilling results in a producing well, the landowner will receive periodic royalty payments in accordance with the terms of the lease for the landowner's share of the oil and gas. This royalty income will continue over the productive life of the drilling unit. Royalty payments are reported in Box 2 of Form 1099 MISC. The payments are considered ordinary income and must be reported on Schedule E (Form 1040) for an individual taxpayer. Royalty payments are not subject to self-employment tax. As explained later, royalty payments can be reduced by allowable depletion and related expenses, if any, to arrive at ordinary income to the landowner.

Ohio and Local Income Tax Payments

Both lease bonus and royalty payments are subject to Ohio income tax. In addition, some landowners may be subject to local income tax on the payments. This most often occurs when the landowner's place of residence is within an incorporated area that has a local income tax; the tax applies even if the leased land is not within the incorporated area.

Estimated Tax Payments

Lease bonus and royalty payments can be substantial in nature and may require the landowner to make quarterly estimated tax payments. Landowners who fail to make estimated tax payments may incur penalties. For this reason, it is important for landowners to consult with a tax professional to determine if estimated tax payments are necessary.

Under usual circumstances, farmers who file their taxes by March 1 are not required to pay estimated taxes. However, landowners who receive oil and gas income may not be classified as a "farmer" for estimated tax purposes, which requires that two-thirds of gross income is received from Schedule F activities. If the landowner is not able to meet the "farmer" classification, the landowner must pay estimated taxes on all of their income.

Income Tax Management Strategies

Making management decisions to minimize taxes is appropriate; evading taxes is not a wise management decision and is illegal. Landowners can utilize tax management strategies to help reduce the tax burden. Following are summaries of potential options that can impact a landowner's income tax liability. The landowner's individual situation will affect the desirability and usefulness of each strategy.

Depletion Deductions

The IRS recognizes that oil, gas, and other minerals are used up or depleted as they are extracted and allows for a reasonable deduction based on depletion of the resource. To qualify for the depletion deduction, the landowner must have an ownership interest in the mineral property and a legal right to income from the oil and gas extraction. The deduction is allowed only when oil or gas is sold and income is reportable.

The IRS requires a landowner to compare two methods when calculating the deduction and to use the method that provides the largest deduction. Because most landowners do not have a cost basis in the minerals, they automatically must use the percentage depletion method.

- Cost depletion – A unit of production that uses the landowner’s basis in the property.
- Percentage depletion – A specified percentage (15% for natural gas) of the landowner’s gross income from the property, limited to the lesser of 15% of the landowner’s taxable income from the property or 65% of the landowner’s taxable income from all sources times 15%.

Example of Percentage Depletion:

Farmer Jefferson received royalty income of \$12,055. This is the only income received from his real estate. To calculate the percentage depletion, Farmer Jefferson multiplies \$12,055 by 15%, which equals \$1,808. He then compares this to the taxable income from all sources, say \$30,000. The percentage depletion limit would be \$30,000 times 65% times 15%, which equals \$2,925. Because \$1,808 is smaller than \$2,925, Farmer Jefferson’s depletion would be \$1,808 for line 18 on Schedule E.

Attorney Fees

In many cases, the landowner hires an attorney to assist in negotiations, title work or lease review. The law allows a deduction for fees paid to an attorney who assists a landowner with attempting to produce taxable income. If the landowner is a member of a landowner association, the landowner may only deduct his or her actual share of the association’s attorney fees. If a payment for legal fees is \$600 or more, the amount must be reported on Form 1099 MISC, Box 14, Gross Proceeds Paid to an Attorney.

Retirement and Salary Reduction Plans

Contributions to an IRA or other retirement plan such as 401K, 403B and 457 may lessen your tax burden, but there are limits as to how much can be contributed each year. These limits are established annually by the Internal Revenue Service. Landowners are encouraged to seek the advice of a qualified financial professional to determine the benefits and limitations.

Prepaid Taxes and Mortgage Interest

Taxpayers may pre-pay their Ohio income tax, real estate taxes and mortgage interest for the upcoming year, thus allowing the expenses to be itemized on Schedule A for federal tax purposes. Note that making these elections could affect the landowner’s Alternative Minimum Tax (AMT) calculation. Professional guidance is suggested before prepaying these expenses.

Charitable Giving

Contributions made to qualified organizations, such as those with 501(C)(3) status, churches and other qualified organizations, can help lower tax liability. Current contributions are limited to 50% of the taxpayer’s adjusted gross income with excess contributions permitted to be carried to future years. For donations of \$250 or more written confirmation is required.

Minimizing Profit from Schedule F and Schedule C Businesses

Because these schedules flow back to the 1040, business owners may find it advantageous to limit business profit during the year they receive a large bonus payment. Farmers can prepay expenses for feed, seed, fertilizer, and chemicals. While not related to oil and gas production, these pre-paid expenses can still reduce the landowner’s overall tax burden. It’s important to follow specific rules for these expenses as there are defined limits.

Section 179 Expensing and Accelerated First Year Depreciation allowances have allowed businesses to write off capital expenditures immediately minimizing taxable income or creating a loss from these schedules. There are special rules for using these accelerated depreciation measures. For instance, the current limit for Section 179 expensing is limited to farm income and has a yearly maximum (\$139,000 in 2012). Accelerated First Year Depreciation is limited to 50% of the purchase price for 2012. Because depreciation is an amortized deduction, purchasing assets which are to be depreciated to reduce your tax liability may not be the best use of your cash. Evaluate your current situation to determine if purchasing depreciable assets is appropriate. Taxpayers should be aware that changes to the percentage and limitation amounts often change during the tax year; often in the taxpayer's favor. Consultation with a tax professional is highly suggested.

Loss Limitations. Note that for years beginning after 2009, excessive farm losses are not deductible for farmers who receive certain subsidies such as direct or counter cyclical payments. Farmers receiving these payments are limited to the greater of \$300,000 or the total net farm income for the prior five tax years. These loss limitations may affect farmers who are receiving oil and gas lease bonus or royalty payments and who are using accelerated depreciation as a method to create a loss on their Schedule F to offset the gain from the oil and gas payments. For more information, see the 2011 Farmer's Tax Guide, page 26.

Operating Expenses for Oil and Gas

Landowners who hold an operating or working interest in the production of oil and gas can deduct intangible drilling and development costs, operating expenses, geological and geophysical expenses, production taxes and depletion expenses.

Other Financial and Tax Considerations

Landowners should be aware that oil and gas revenues raise other tax implications. Examples include Commercial Activity Tax (CAT), Current Agricultural Use Valuation (CAUV), property taxes, estate taxes and gift taxes. Capital gains income could be an issue where there is a sale of real property.

Many have asked about using oil and gas revenues to pay off debt. Unfortunately, payments of principal on a loan are NOT deductible. Only the interest portion of a loan payment is tax deductible.

How Much Will I Owe in Income Taxes for My Oil and Gas Payments?

The answer to this question depends upon the landowner's tax bracket. Oil and gas payments are added to other income the landowner received to determine the applicable tax bracket. Following are the current federal and state income tax brackets for married taxpayers filing jointly.

Currently, the highest federal income tax bracket is 35% for those with an adjusted gross income (AGI) of \$379,150 or higher. The highest Ohio income tax bracket is 5.925% for those with Ohio taxable income over \$204,200. When combined, these two equal 40.925%. This is the marginal tax bracket. The oil and gas landowner's average taxable income will probably be lower than the marginal tax bracket because of how the tax is calculated--income tax is calculated for each tax bracket the taxpayer passes through on the way to the 35% rate. Based on this information, a *landowner who reserves 40% of the oil and gas revenue for income taxes* should be able to meet the combined federal and state tax liabilities.

2011 Tax Rates for Married Taxpayers Filing Jointly

Federal Income Tax Rates

Taxable Income	Tax	On Amount Over
\$0 - \$17,000	10%	\$0
\$17,000 - \$69,000	\$1,700 + 15%	\$17,000
\$69,000 - \$139,150	\$9,500 + 25%	\$69,000
\$139,350 - \$212,300	\$22,087.50 + 28%	\$139,350
\$212,300 - \$379,150	\$47,513.50 + 33%	\$212,300
\$379,150 and over	\$102,574 + 35%	\$379,150

Ohio 2011 Tax Rates

Taxable Income	Tax	On Amount Over
\$0 - \$5,100	0.597%	\$0
\$5,100 - \$10,200	\$29.94 + 1.174%	\$5,100
\$10,200 - \$15,350	\$89.81 + 2.438%	\$10,200
\$15,350 - \$20,450	\$210.73 + 2.935%	\$15,350
\$20,450 - \$40,850	\$360.42 + 3.521%	\$20,450
\$40,850 - \$81,650	\$1,078.70 + 4.109%	\$40,850
\$81,650 - \$102,100	\$2,755.15 + 4.695%	\$81,650
\$102,100 - \$204,200	\$3,715.30 + 5.451%	\$102,100
\$204,200 and over	\$9,280.77 + 5.925%	\$204,200

Example 1:

John & Jane Doe, husband and wife, use the married filing jointly option, have two exemptions, are under age 65, and use the standard deduction. Their combined wages, retirement income, interest, Schedule F, and Schedule C income equals \$50,000 gross. Of the \$50,000 in gross income, \$31,300 is considered taxable income.

Example 2:

Assuming John & Jane Doe receive a lease payment of \$250,000, their taxable income is \$281,300 (\$31,000 + \$250,000). Of this total, \$70,714 will be paid in federal income taxes and \$15,587 will be paid in Ohio taxes, for a combined total tax bill of \$86,301.

Example 3:

Let's assume John & Jane Doe receive a lease bonus payment of \$500,000. Their taxable income in the base case remains the same at \$31,300. However, the total taxable income will increase to \$531,300 (\$31,300 + \$500,000). In this example the federal income tax is \$156,263 and the Ohio income tax is \$31,187, for a combined total tax bill of \$187,450. If this couple were to receive a lease bonus payment of \$1,000,000, they would pay \$388,388 in taxes.

Conclusion

For landowners leasing their oil and gas mineral rights, there is the potential for significant income. A landowner should set aside 40% of oil and gas income in preparation for income tax liability. While a landowner can't avoid paying income taxes on oil and gas revenues, the landowner can use strategies to minimize income tax liability. To do so, a landowner should seek the assistance of a qualified attorney and accountant before, during, and after the negotiations to fully understand and utilize all available tax management strategies.

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Many Thanks to Our Reviewers

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