OIL AND GAS *TAX ADVISORY*

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The taxation of income from natural resources is one of the most complex areas of the federal tax law. Especially complex are issues surrounding the taxation of oil and gas income received by property owners.

Generally, instead of selling the property, the property owner will receive an upfront cash payment from a driller for the right to explore and drill on the owner's property. This payment is ordinary income in the year it is received.

The other normal source of income for a mineral interest holder is a royalty payment. This royalty payment is based on a percentage of the oil and gas production. In Pennsylvania, the royalty ranges from a minimum of 12½% to as high as 18%. This income is also taxed as ordinary income in the year in which it is received by a cash basis taxpayer.

Oil and gas deposits are wasting or depleting assets. Somewhat akin to depreciation for buildings and equipment, the Internal Revenue Code allows two methods of claiming a tax deduction for the depletable asset. The first method provided is cost depletion. This concept is based on a formula that is the depletable property basis (usually the purchase price) divided by the number of units (barrels of oil or mcf of gas) at year end plus the number of units sold during the year times the number of units sold during the year.

The alternative to cost depletion is percentage depletion (or statutory depletion). Percentage depletion is only available to independent producers and land owners and allows a depletion deduction of 15% of the gross income

from the taxpayer's production, limited to the annual depletable gas quantity of 6,000,000 cubic feet of gas (or 1,000 barrels of oil). Any production in excess of these amounts is not entitled to a percentage depletion deduction.

The Internal Revenue Code allows taxpayers to deduct the higher of cost depletion or percentage depletion against the royalty income.

Several other rules surround the use of percentage depletion: first, percentage depletion is computed on each separate property, rather than combined income from all producing properties; second, the amount of percentage depletion cannot exceed 100% of taxable income from the property and 65% of the taxpayer's taxable income for the year.

Both cost and percentage depletion reduce the basis of the property. However, the excess percentage depletion over cost depletion is not limited to the taxpayer's tax basis in the property.

The attorneys at Metz Lewis have significant experience in the oil and gas industry in general and the taxation of the oil and gas in particular. Should you have any questions surrounding any aspect of this matter or structuring a transaction, please contact LeRoy Metz (412-918-1101 - lmetz@metzlewis.com) or Larry Blair (412-918-1123 - lblair@metzlewis.com).