

**PENNSYLVANIA PERSONAL INCOME TAX GUIDE**

**CHAPTER 23: NATURAL RESOURCES**

**TABLE OF CONTENTS**

<b>I. FEDERAL INCOME TAX TREATMENT OF DEPLETION .....</b>	<b>3</b>
A. Depletion – Overview .....	3
B. Federal Statute.....	3
C. Economic Interest .....	4
D. Cost Depletion.....	4
E. Units Sold.....	4
F. Adjusted Basis of Property .....	5
G. Reserves .....	5
H. Gross Income from the Property .....	5
I. Net Income of the Property .....	6
J. Expense of the Property.....	6
K. Overhead Allocation .....	6
L. Passive Activity Loss Limitation.....	6
M. Various Percentage Depletion Rates.....	7
<b>II. PENNSYLVANIA PERSONAL INCOME TAX TREATMENT OF DEPLETION.....</b>	<b>7</b>
A. Overview.....	7
B. Pennsylvania Personal Income Tax Treatment of Federal Percentage Depletion .....	7
C. Classification and Adjustments.....	8
<b>III. PENNSYLVANIA PERSONAL INCOME TAX TREATMENT OF ROYALTIES AND RENTS.....</b>	<b>8</b>
A. Taxable Royalties.....	8
B. Taxable Rental Income .....	9
<b>IV. PENNSYLVANIA PERSONAL INCOME TAX TREATMENT OF TIMBER .....</b>	<b>9</b>
A. Net Profits; Net Gains or Income From Disposition of Property; and Net Gains or Income Derived From or in the Form of Rents, Royalties, Patents and Copyrights Defined.....	9
B. PA-40 Schedule D-Gain (Loss) Defined .....	10
C. Commercial Enterprise Defined .....	10
D. PA-40 Schedule D-Gain (Loss) and Resident Credit .....	10
E. Income From Pay-As-Cut Contract Classified as Royalties .....	10
F. Taxpayer Retains An Economic Interest in the Timber After Being Cut.....	11
<b>V. FEDERAL INCOME TAX – S CORPORATION CONSIDERATION .....</b>	<b>11</b>
A. Allowance for Depletion Calculated Separately for Each Shareholder .....	11
B. Basis Consideration.....	11
C. Accumulated Adjustments Account Consideration .....	12
<b>VI. PENNSYLVANIA PERSONAL INCOME TAX – S CORPORATION CONSIDERATION.....</b>	<b>12</b>
<b>VII. FEDERAL INCOME TAX – PARTNERSHIP CONSIDERATION.....</b>	<b>12</b>
A. Separately Stated Items .....	12
B. Basis Adjustments .....	12

**PENNSYLVANIA PERSONAL INCOME TAX GUIDE**

**VIII. PENNSYLVANIA PERSONAL INCOME TAX – PARTNERSHIP CONSIDERATION..... 13**

**IX. FEDERAL INCOME TAX TREATMENT OF INTANGIBLE DRILLING COSTS ..... 13**

    A. Intangible Drilling Costs – Overview ..... 13

    B. Federal Tax Treatment– Intangible Drilling Costs..... 14

    C. Exploration Costs..... 15

**X. PENNSYLVANIA PERSONAL INCOME TAX TREATMENT OF INTANGIBLE DRILLING COSTS..... 15**

    A. Intangible Drilling Costs Amortized, Not Deductible..... 15

    B. Write-Off Remaining Un-amortized Cost of Unproductive Wells ..... 15

    C. Pennsylvania Personal Income Tax Classification and Adjustment ..... 15

## PENNSYLVANIA PERSONAL INCOME TAX GUIDE

### CHAPTER 23: NATURAL RESOURCES

#### I. FEDERAL INCOME TAX TREATMENT OF DEPLETION

##### A. Depletion – Overview

Section 611(a) of the Internal Revenue Code provides, in part, that in the case of mines, oil and gas wells, other natural deposits and timber, there will be allowed as a deduction in calculating taxable income a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary.

There are two methods for calculating depletion, cost and percentage. The taxpayer must take the greater deduction of the two methods. Both methods are on a property-by-property basis. The cost depletion method is essentially a units-of-production method. For the taxpayer to receive the benefit of a cost depletion deduction, the taxpayer must have basis available in the property. The percentage depletion deduction is based on a percentage (currently 15 percent) of gross income from the property.

Internal Revenue Code (IRC) Section 613A(c)(6), amended by the Revenue Reconciliation Act of 1990, increases the percentage depletion with respect to marginal production properties for tax years beginning after Dec. 31, 1990. The increase is 15 percent, plus 1 percentage point for each whole dollar that the "reference price" for crude oil [for the immediately preceding calendar year] is less than \$20 per barrel. The amount of the percentage depletion deduction is limited to 50 percent (or 100 percent after 1990) of the net income of the property, performed on a property-by-property basis, and 65 percent of the taxpayer's taxable income. The allowable depletion deduction is the greater of the two methods.

##### B. Federal Statute

Section 613(a) provides, in part, that in the case of the mines, wells and other natural deposits listed in subsection (b), the allowance for depletion under Section 611 will be the percentage, specified in subsection (b), of the gross income from the property excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. In no case will the allowance for depletion under Section 611 be less than it would be if calculated without reference to this Section.

Section 613(c)(1) provides that the term "gross income from the property" means, in the case of a property other than an oil or gas well and other than a geothermal deposit, the gross income from mining.

Section 613(d) states that, except as provided in Section 613A, in the case of any oil or gas well, the allowance for depletion will be calculated without reference to §613.

## PENNSYLVANIA PERSONAL INCOME TAX GUIDE

Section 613(e)(1) provides that in the case of geothermal deposits located in the United States or in a possession of the United States, for purposes of subsection (a)–

1. Such deposits will be treated as listed in subsection (b), and
2. 15 percent will be deemed to be the percentage specified in §613(b).

### **C. Economic Interest**

A taxpayer must have an economic interest in the property to claim a deduction for depletion; with the exception of production payments treated as loans and installment bonuses under IRC Section 636. The law further limits the taxpayers entitled to a percentage depletion deduction to entities that qualify as independent producers and certain royalty owners.

A taxpayer has an economic interest when it has acquired any interest in a mineral in place, by any form of legal relationship, and has vested rights to the income from the extraction of the mineral that is looked to for a return of capital. A person who has no capital investment in the mineral deposit does not have an economic interest merely because the taxpayer gains an economic or monetary advantage from production through a contractual relationship. The contractual right to purchase oil or gas after it has been produced is an example of an economic advantage. Such an economic advantage is not an economic interest sufficient to claim a deduction for depletion. *See* Revenue Ruling 68-330, 1968-1 C.B. 291.

### **D. Cost Depletion**

The cost depletion deduction assures the owner of an oil and gas producing property a tax deduction equal to the investment in the mineral property as the reserves are depleted. The basis for cost depletion is defined under IRC Section 612. "The basis on which depletion is to be allowed in respect of any property shall be the adjusted basis provided in Section 1011."

### **E. Units Sold**

In the selection of a unit of mineral for depletion, preference shall be given to the principal or customary unit or units paid for in the products sold, such as barrels of oil or Mcf (1000 cubic feet) for gas. Some taxpayers convert barrels of oil to Mcf of gas, or gas to barrels, by reference to the value of each. Thus, both oil and gas enter into the calculation, although Treasury Regulation Section 1.611-2(a) indicates only one should be used. This usually results in an equitable deduction. Any adjustment to the method usually is small and insignificant.

For a cash basis taxpayer, units sold include only units for which payment was received during the period. For an accrual basis taxpayer, the units sold shall be determined from the taxpayer's inventories kept in physical quantities and in a manner consistent with his or her method of inventory accounting under IRC Section 471 or Section 472. No units should be included for which depletion was allowed in a prior period.

## PENNSYLVANIA PERSONAL INCOME TAX GUIDE

If the taxpayer received prior period price adjustments and included the barrels or Mcf in the current period the "units sold" for cost depletion are excluded.

### **F. Adjusted Basis of Property**

An allowable deduction for depletion (cost or percentage) will reduce the basis of a property, as determined under IRC Section 1011, for the cost depletion calculation. Cost depletion is limited to the adjusted basis of the property, whereas percentage depletion can exceed it. Taxpayers should maintain accounts, which have accumulated all the capitalized costs and allowable depletion (percentage and cost) by property. If costs exceed the depletion reserve (accumulated depletion), the difference is the remaining basis. The effect of this is that an addition to capital of any asset may be fully offset by previously allowed percentage depletion, so that immediately after a substantial capitalization, the taxpayer's remaining basis may be zero. See Revenue Ruling 75-451, 1975-2 C.B. 330 and Treasury Regulation §1.614-6 (a)(3), Example 1.

### **G. Reserves**

The reserves to be included in the calculation of cost depletion for federal income tax purposes include proved and probable reserves in accordance with Treasury Regulation Section 1.611-2(c). Regulations indicate probable or prospective reserves are to be included only if they are extensions of known deposits or are new bodies of mineral whose existence is indicated by a high degree of probability.

### **H. Gross Income from the Property**

Gross income per the tax return and gross income per the depletion schedule will generally not be the same. Various adjustments must be made to determine gross depletable income. Examples of oil and gas revenues per the general ledger may be gas sales, oil sales, condensate sales, plant products, royalty gas sales, royalty oil sales, and royalty condensate sales. Plant products are not gross depletable income. Examples of accounts not included in depletable income are plant operating income (for example, propane, butane, and ethane sales), marketing income, truck rentals, pipeline fees and consulting fees.

There are several adjustments to book income to determine income subject to depletion-

- 1. Transportation Costs**

These costs must be isolated from production income.

- 2. Lease Bonus Exclusion**

Gross income is reduced by a portion of the bonus payment to arrive at depletable income.

- 3. Royalty Income**

If paid by the working interest owner, it must be excluded from depletable income.

## PENNSYLVANIA PERSONAL INCOME TAX GUIDE

4. **Advanced Royalties**

Gross income is reduced by a portion of the advanced royalty payment to arrive at depletable income.

5. **Delay Rentals**

When received by the landowner, delay rentals are not payments for production of oil and gas and are not subject to depletion.

6. **Taxes**

The amount received by a producer is usually net of production and severance taxes; this amount received generally needs to be grossed up by the amount of the taxes for depletion purposes.

**I. Net Income of the Property**

Percentage depletion is calculated on a property-by-property basis. Taxable income from the property is important because the percentage depletion deduction is limited to a percentage of taxable income from the property, calculated without regard to depletion allowance, per IRC Section 613(a). For taxable years beginning before Jan. 1, 1991, the net income limitation is 50 percent. For taxable years beginning after Dec. 31, 1990, the net income limitation has been increased from 50 percent to 100 percent of net taxable income in the case of oil and gas properties. The increased limitation, 100 percent, is applicable only to oil and gas properties.

**J. Expense of the Property**

The taxpayer can claim various expenses (for example, lease operating, severance taxes, production taxes, depreciation, overhead, *etc.*) to calculated each property's net income. These expenses will be directly attributable to the property or the taxpayer will be required to use an allocation method.

**K. Overhead Allocation**

Expenses must be separated between direct and indirect. Each separate activity should draw a portion of the overhead that is incurred.

**L. Passive Activity Loss Limitation**

Internal Revenue Code Section 469(a) denies any net losses or tax credits from passive activities. Losses and credits from passive activities may only reduce income from other passive activities. The excess is carried forward to subsequent years to offset passive activity income arising in those years.

The passive activity loss limitation is applied after the percentage depletion limitations. The portion of the percentage depletion deduction carried over to a subsequent year due to the 65 percent of taxable income limitation is allowed without regard to the application of IRC Section 469 in that year.

## PENNSYLVANIA PERSONAL INCOME TAX GUIDE

### M. Various Percentage Depletion Rates

The various percentage depletion rates are contained in IRC Section 612(b). The rates range from a high of 22 percent for sulphur and uranium to 5 percent for gravel, peat, pumice, sand, certain shale and stone. Oil shale, gold, silver, copper and iron ore are at 15 percent.

## II. PENNSYLVANIA PERSONAL INCOME TAX TREATMENT OF DEPLETION

### A. Overview

Pennsylvania Regulation Section 125.51, Allowance of deduction for cost depletion provides in part -

“In the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction in calculating income a reasonable allowance for depletion. In any case which it is ascertained as a result of operations or development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this section for subsequent taxable years shall be based on such revised estimate.

Recoverable units - Recoverable units are the number of units (*e.g.*, tons, pounds, ounces or barrels) of minerals, oil or gas in the ground and economically worth extracting, estimated according to the best available information and industry standards.

Basis for depletion - The basis on which depletion is to be allowed in respect of any property shall be the adjusted basis for the purpose of determining the gain upon the sale or other disposition of such property.”

### B. Pennsylvania Personal Income Tax Treatment of Federal Percentage Depletion

The allowance of deductions for percentage depletion is **not** generally acceptable by standards of the accounting profession and constitutes an unconstitutional item of tax preference under the *Pennsylvania Constitution* after the cost of recoverable units has been fully recovered. Effective for taxable years beginning on or after Jan. 1, 2005, a deduction for percentage depletion shall be allowed **only** in the following set of circumstances -

1. It is allowable as a deduction in computing federal taxable income.
2. Insufficient information is available to estimate the amount of recoverable units in accordance with industry standards.
3. The cost of the recoverable units is fixed and certain.
4. The cost of the recoverable units has not been fully recovered.

## PENNSYLVANIA PERSONAL INCOME TAX GUIDE

(Adopted- Effective Nov. 9, 2004)

The taxpayer must have un-recovered basis in the property in order to receive the benefit of a deduction for percentage depletion.

### **C. Classification and Adjustments**

Classification and adjustments are required to the respective Pennsylvania personal income tax reporting base to account for annual differences between the taxpayer's federal depletion deduction and the taxpayer's allowable Pennsylvania personal income tax depletion deduction.

## **III. PENNSYLVANIA PERSONAL INCOME TAX TREATMENT OF ROYALTIES AND RENTS**

### **A. Taxable Royalties**

Article III of the Tax Reform Code of 1971 (Tax Reform Code) provides that every resident individual, estate or trust shall pay (be taxed on each dollar of income) for the privilege of receiving each of the classes of income from all sources, and that every nonresident individual, estate, or trust shall pay (be taxed on each dollar of income) from Pennsylvania sources (*i.e.*, compensation earned for services performed in Pennsylvania). The Tax Reform Code provides the following eight classes of taxable income: 1) Compensation; 2) Interest; 3) Dividends; 4) Net income or [Loss] from the operation of a business, profession or farm; 5) Net gain or [loss] from sale, exchange or disposition of property; 6) Net income or [loss] from rents, royalties, patents and copyrights; 7) Estate and trust income; and, 8) Gambling and lottery winnings. See 72 P.S. §§7302, 7303.

Royalties are not defined under the Tax Reform Code. However, in *Tygart Resources, Inc. v. Com.*, 134 Pa. Comwlth. 168, 578 A.2d 86 (Pa. Comwlth. 1990) the Commonwealth Court of Pennsylvania stated --

"Section 1903(a) of the Statutory Construction Act of 1972, 1 Pa. C.S. §1903(a) provides that words shall be construed according to their common and approved usage, but technical words shall be construed according to their peculiar and appropriate meaning."

*Webster's Third New International Dictionary 1982 (1986)* pertinently defines royalty as follows:

"A share of the product or profit of property reserved by the owner when the property is sold, leased, or used or a payment (a percentage of the amount of property used) to the owner for permitting another to exploit or market such property (as natural resources, patents, or copyrights) which is often subject to depletion with use."

## PENNSYLVANIA PERSONAL INCOME TAX GUIDE

Residents are subject to Pennsylvania personal income tax on income from all sources. Only nonresidents of Pennsylvania allocate royalty income, since only their Pennsylvania source income (portion allocable to Pennsylvania) is subject to Pennsylvania personal income tax.

### **B. Taxable Rental Income**

Taxable rental income consists of income the taxpayer receives for the use of real or tangible property. Royalty income is income the taxpayer receives upon the extraction of coal, oil, gas or other minerals, or for the use of a patent or copyright. Gross rents and royalties include all items of gross income or receipts from rents, royalties, patents, copyrights, secret processes, formulas, good will, trademarks, trade brands, franchises and similar property derived in the form of rents and royalties. However, gross rent and royalties does not include -

1. Income or receipts from the sale, exchange or other disposition of rental property, royalty rights, copyrights, secret processes, patents, formulas, good will, trademarks, trade brands, franchises and similar property;
2. Income or receipts from operating oil, gas, or mineral interests includable in the calculation of net profits from a business, profession or farm, or otherwise derived in the ordinary course of and from the operation of a business; and
3. If the taxpayer retains an economic interest in the coal, oil, gas or other minerals after being extracted (*i.e.* will receive a percentage of future sales), then the proceeds received would constitute net gains or income derived from royalties. In computing net gain or income from royalties, taxpayer is permitted to offset ordinary and necessary expenses incurred in receiving this royalty gain or income. [See Section 631 of the Internal Revenue Code.]

## **IV. PENNSYLVANIA PERSONAL INCOME TAX TREATMENT OF TIMBER**

### **A. Net Profits; Net Gains or Income from Disposition of Property; and Net Gains or Income Derived From or in the Form of Rents, Royalties, Patents and Copyrights Defined**

Pennsylvania's Tax Reform Code of 1971, as amended, contains eight separate classes of income. Three of the items of income are defined as -

1. **Net profits**  
The net income from the operation of a business, profession or other activity after provision for all costs and expenses incurred in the conduct thereof ... determined in accordance with accepted accounting principles and practices but without deduction of taxes based on income.

## PENNSYLVANIA PERSONAL INCOME TAX GUIDE

2. **Net gains or income from disposition of property**

Net gains or net income, less net losses, derived from the sale, exchange or other disposition of property, including real or personal, whether tangible or intangible as determined in accordance with accepted accounting principles and practices.

3. **Net gains or income derived from or in the form of rents, royalties, patents and copyrights.** This income is reportable on *PA-40 Schedule E – Rents and Royalty Income (Loss)*. See 72 P.S. §7303(a)(2), (3) and (4).

**B. PA-40 Schedule D – Gain (Loss) Defined**

For Pennsylvania personal income tax purposes, timber products are treated as "property" for purposes of taxation and the income is properly classifiable as proceeds from the disposition of property. The income from such disposition is reportable on *PA-40 Schedule D – Sale, Exchange or Disposition of Property* unless the sale of the timber is part of a commercial enterprise.

**C. Commercial Enterprise Defined**

Pennsylvania courts have held that the essential element of a commercial enterprise is the rendering of goods and services to others in a marketplace. *Wettach v. Com.*, 620 A.2d 730 (Pa. Cmwlth. 1993); *Morgan v. Com.*, 400 A.2d 1384 (Pa. Cmwlth. 1979).

In order to classify the proceeds from the sale of trees (timber products) as business income it must be shown that the timber is marketed to customers on a commercial basis and without limitation or exclusivity (*i.e.* it is sold to the general public and not to an exclusive number of customers). Additionally, the marketing activity must be conducted with the manifest objective of achieving profitable operations and it must be conducted with regularity and continuity.

**D. PA-40 Schedule D – Gain (Loss) and Resident Credit**

For Pennsylvania personal income tax purposes, if the taxpayer's timber sales were not the result of a commercial enterprise or net gains derived from royalties then the timber products are treated as "property" and the income would be classifiable as Schedule D, gain (loss). The gain is the difference between the amount realized and taxpayers' basis in the timber. The income from such disposition is reportable on *PA-40 Schedule D – Sale, Exchange or Disposition of Property*.

A resident is subject to tax on the net gain from making a disposition of property irrespective of whether the property is located inside or outside of the Commonwealth. To avoid the double taxation of income, however, the statute also includes a resident tax credit provision.

**E. Income From Pay-As-Cut Contract Classified as Royalties**

Income from the sale of timber outside a commercial enterprise is generally classified as net gains or income from the disposition of property. However, the fact that a sale was made under a pay-as-cut contract changes the classification of the income.

## PENNSYLVANIA PERSONAL INCOME TAX GUIDE

The IRS Announcement 1990–129, indicates that timber sales under a pay-as-cut contract are royalties. Royalties are not defined under the Tax Reform Code. However, as discussed previously in *Tygart Resources, Inc. v. Commonwealth*, the Commonwealth Court of Pennsylvania stated -

“Section 1903(a) of the Statutory Construction Act of 1972, 1 Pa. C.S. §1903(a) provides that words shall be construed according to their common and approved usage, but technical words shall be construed according to their peculiar and appropriate meaning.”

### **F. Taxpayer Retains An Economic Interest in the Timber After Being Cut**

If the taxpayer retains an economic interest in the timber after being cut (*i.e.* will receive a percentage of future sales), then the proceeds received would constitute net gains or income derived from royalties. In computing net gain or income from royalties, taxpayer is permitted to offset ordinary and necessary expenses incurred in receiving this royalty gain or income. This income is reportable on *PA-40 Schedule E – Rents and Royalty Income (Loss)*.

## **V. FEDERAL INCOME TAX – S CORPORATION CONSIDERATION**

### **A. Allowance for Depletion Calculated Separately for Each Shareholder**

Section 613A(c)(11)(A) of the Code provides that, in the case of an S corporation, the allowance for depletion with respect to any oil or gas property shall be calculated separately by each shareholder.

Section 613A(c)(11)(B) of the Code provides that the S corporation will allocate to each shareholder his pro rata share of the adjusted basis of the S corporation in each oil or gas property held by the S corporation. The allocation will be made as of the later of the date of acquisition of the property by the S corporation or the first day of the first taxable year of the S corporation to which the Subchapter S Revision Act of 1982 applies. Each shareholder will separately keep records of his share of the adjusted basis in each oil or gas property of the S corporation, adjust each share of the adjusted basis for any depletion taken on the property, and use the adjusted basis each year in the computation of the cost depletion or in the computation of the gain or loss on the disposition of such property by the S corporation. In the case of any distribution of oil or gas property to its shareholders by the S corporation, the corporation's adjusted basis in the property will be an amount equal to the sum of the shareholders' adjusted basis in the property, as determined under this subparagraph.

### **B. Basis Consideration**

A shareholder's S corporation stock basis is increased by the shareholder's portion of the excess of the corporation's depletion deductions over the basis of the property subject to depletion.

However, no increase in basis may be made for any pass through item of corporate gross income unless that increase is, in fact, reported on the shareholder's tax return.

## PENNSYLVANIA PERSONAL INCOME TAX GUIDE

Stock basis is then decreased (but not below zero) for the shareholder's portion of the depletion deduction for any oil or gas wells held by the S corporation to the extent that this deduction does not exceed the shareholder's proportionate share of the adjusted basis of the property.

### **C. Accumulated Adjustments Account Consideration**

The accumulated adjustments account (AAA) (See IRC Section 1368(e)) is used to calculate the tax effect of distributions made by an S corporation with earnings and profits. The balance of the accumulated adjustments account is zero at the beginning of the tax year when the corporation first elects S corporation status.

The accumulated adjustments account is increased for the excess of depletion deductions over the basis of property subject to depletion (except certain oil and gas property).

## **VI. PENNSYLVANIA PERSONAL INCOME TAX – S CORPORATION CONSIDERATION**

The deduction for depletion is calculated at the S corporation level. Pennsylvania personal income tax rules do not allow a deduction for depletion in excess of basis in the property. If the taxpayer's basis is negative, then the taxpayer must adjust the capital account.

See Pennsylvania Personal Income Tax Guide Chapter 16, Pass Through Entities.

## **VII. FEDERAL INCOME TAX – PARTNERSHIP CONSIDERATION**

### **A. Separately Stated Items**

While a partnership's income is generally calculated like that of an individual, there are certain exceptions. As stated above, a number of items must be separately stated. See IRC Section 703(a)(1). Furthermore, several deductions are not permitted in computing partnership income since these deductions will be made instead at the partner level. The impermissible deductions include the IRC Section 611 deduction for oil and gas well depletion.

IRC Section 613A(c)(7)(D) provided in part that in the case of a partnership the depletion allowance shall be calculated separately by the partner and not by the partnership. The partnership allocates to each partner his or her proportionate share of the adjusted basis of each partnership's oil and gas property.

### **B. Basis Adjustments**

This initial partner basis in the partnership interest is adjusted over time as follows --

1. Basis is increased by the sum of the partner's distributive share for the tax year and prior tax years for the excess of the deductions for depletion over the basis of the property subject to depletion.
2. Basis is also decreased, but not below zero, by the amount of the partner's deduction for certain oil and gas well depletion. See IRC Section 705(a)(3).

## PENNSYLVANIA PERSONAL INCOME TAX GUIDE

### VIII. PENNSYLVANIA PERSONAL INCOME TAX – PARTNERSHIP CONSIDERATION

All partnership elections are applicable equally to all partners but any election made by the partnership will not apply to any partner's other income or gain outside the partnership. The deduction for depletion is calculated at the partnership level. Pennsylvania personal income tax rules do not allow a deduction for depletion in excess of basis in the property. If the taxpayer's basis is negative, then the taxpayer must adjust the capital account.

See Pennsylvania Personal Income Tax Guide Chapter 16, Pass Through Entities.

### IX. FEDERAL INCOME TAX TREATMENT OF INTANGIBLE DRILLING COSTS

#### A. Intangible Drilling Costs – Overview

There are many costs incurred in developing an oil and gas well. For federal income tax purposes, these costs are classified into two groups: intangible drilling costs (referred to as IDC) and tangible equipment costs. The distinction between these two costs is very important; they are treated differently for tax purposes.

Intangible drilling costs are expenditures for drilling wells or developing wells (preparing them to produce) which are intangible, or which have no salvage value in themselves. Pursuant to Treasury Regulation Section 1.612-4(a), intangible drilling costs are expenditures made by an operator for wages, fuel, repairs, hauling, supplies, *etc.*, incident to and necessary for the drilling of wells and the preparation of the well for the production of oil and gas. Treasury Regulation Section 1.612-4(a) provides for the option with respect to intangible drilling and development costs.

Intangible drilling costs are all costs, which are the intangible or non salvageable costs of drilling up to and including the cost of installing a system of pipes, valves and fittings. The term "Christmas tree" in the oil and gas industry refers to the pipes, valves, and fittings that are used to regulate the flow of oil and gas from the wellhead. The physical arrangement of these pipes and valves resemble a "Christmas tree." The cost of casing and the physical components of the "Christmas tree" are not intangible drilling costs, but equipment costs that are capitalized and depreciated.

A working interest owner in an oil or gas property has the option to elect to currently deduct intangible drilling cost. This option, granted by Treasury Regulation Section 1.612-4(a), is exercised by claiming intangible drilling cost as a deduction on the taxpayer's federal income tax return for the first taxable year in which the taxpayer pays or incurs such costs. No formal statement is necessary. If the owner of the lease is a partnership, the election must be made at the partnership level. Once the election is made, it is irrevocable and binding for all subsequent taxable years. A taxpayer who fails to claim the expenses on the first return as a deduction is deemed to have elected to capitalize the costs.

If a taxpayer fails to deduct intangible drilling cost as an expense on the first return, the taxpayer is deemed to have elected to capitalize such costs. Recovery of costs will

## PENNSYLVANIA PERSONAL INCOME TAX GUIDE

be done through depletion, to the extent that they are not represented by physical property, and through depreciation, to the extent that they are represented by physical property. See Treasury Regulation Section 1.612-4(b).

The option to expense or capitalize domestic intangible drilling cost is available to all taxpayers, both individuals and corporations, with one exception. Integrated oil companies can deduct only 70 percent of their domestic intangible drilling cost currently.

### **B. Federal Tax Treatment– Intangible Drilling Costs**

As discussed above, the costs of developing oil, gas, or geothermal wells are ordinarily capital expenditures. Taxpayer can usually recover them through depreciation or depletion. However, taxpayer can choose to deduct intangible drilling costs as a current business expense. These are certain drilling and development costs for wells in the United States in which a taxpayer holds an operating or working interest. Taxpayer can deduct only costs for drilling or preparing a well for the production of oil, gas, or geothermal steam or hot water.

Taxpayers can choose to deduct only the costs of items with no salvage value. These include wages, fuel, repairs, hauling, and supplies related to drilling wells and preparing them for production.

Taxpayer's cost for any drilling or development work done by contractors under any form of contract is also an intangible drilling cost.

Taxpayers can also choose to deduct the cost of drilling exploratory bore holes to determine the location and delineation of offshore hydrocarbon deposits if the shaft is capable of conducting hydrocarbons to the surface on completion. It does not matter whether there is any intent to produce hydrocarbons.

Taxpayers elect to deduct intangible drilling costs as a current business expense by taking the deduction on your income tax return for the first tax year you have eligible costs. No formal statement is required. If taxpayer files federal Schedule C (Form 1040), enter these costs under "Other expenses."

For oil and gas wells, taxpayer's choice is binding for the year it is made and for all later years. For geothermal wells, the filing of an amended return on which you do not take the deduction can revoke your choice.

If taxpayer capitalizes his or her intangible drilling costs, a taxpayer has another option if the well is nonproductive. Taxpayers can deduct the intangible drilling costs of the non-productive well as an ordinary loss. Taxpayers must indicate and clearly state their choice on the tax return for the year the well is completed. Once made, the choice for oil and gas wells is binding for all later years. Taxpayers can revoke his or her choice for a geothermal well by filing an amended return that does not claim the loss.

## PENNSYLVANIA PERSONAL INCOME TAX GUIDE

### **C. Exploration Costs**

The costs of determining the existence, location, extent, or quality of any mineral deposit are ordinarily capital expenditures if the costs lead to the development of a mine. Taxpayer recovers these costs through depletion as the mineral is removed from the ground. However, taxpayers can choose to deduct domestic exploration costs paid or incurred before the beginning of the development stage of the mine (except those for oil, gas, and geothermal wells).

Taxpayers elect to deduct exploration costs by taking the deduction on their income tax return, or on an amended income tax return, for the first tax year for which you wish to deduct the costs paid or incurred during the tax year. Taxpayer must adequately describe and identify each property or mine, and clearly state how much is being deducted for each one. The choice applies to all later tax years.

Each partner, not the partnership, chooses whether to capitalize or to deduct that partner's share of exploration costs.

### **X. PENNSYLVANIA PERSONAL INCOME TAX TREATMENT OF INTANGIBLE DRILLING COSTS**

#### **A. Intangible Drilling Costs Amortized, Not Deductible**

Intangible drilling costs associated with the creation of wells are not deductible. As long as the taxpayer or entity is engaged in the active conduct of a business and business activities have begun (beyond the exploration stage), and the drilling costs are reasonable in amount, the expenses may be amortized over the life of the wells.

#### **B. Write-Off Remaining Un-amortized Cost of Unproductive Wells**

An entity can write off the remaining un-amortized cost as a loss when the well proves unproductive. This loss is similar to a federal capital loss not subject to current expensing. Pennsylvania personal income tax rules require the loss to be recorded as a loss on the sale, exchange or disposition of property.

#### **C. Pennsylvania Personal Income Tax Classification and Adjustment**

Pennsylvania personal income tax classification and adjustment must be made to account for Pennsylvania personal income tax difference from federal tax treatment.