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DEPLETION

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."

Pennsylvania Personal Income Tax Treatment of Federal Percentage Depletion

Generally, percentage depletion is not allowable except in the following set of circumstances:

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

Depletion for Pennsylvania Pass Through Entities

The deduction for depletion is calculated at the partnership or 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 PA Personal Income Tax Guide - Pass Through Entities.

PENSYLVANIA PERSONAL INCOME TAX TREATMENT OF INTANGIBLE DRILLING COSTS

Intangible Drilling Costs Amortized, Not Deductible

In general, intangible drilling costs associated with the creation of wells are not currently deductible, but instead must be capitalized and recovered through amortization ratably over a 10-year period.

Election to Currently Expense a Portion of Intangible Drilling Costs

For tax years beginning after December 31, 2014, a taxpayer incurring intangible drilling costs as defined under Section 263(c) of the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder, may elect for Pennsylvania Personal Income Tax purposes to expense up to one-third of such costs in the tax year in which they are incurred and recover the remaining costs through amortization ratably over a 10-year period beginning in the tax year in which they are incurred. A person may expense IDCs for Pennsylvania Personal Income Tax purposes without regard to whether the person currently expenses IDCs for Federal Income Tax purposes under IRC § 263(c) or 59(e). Refer to Information Notice Personal Income Tax 2013-04, for more information.

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.

PENNSYLVANIA PERSONAL INCOME TAX TREATMENT OF ROYALTIES AND RENTS

Taxable Royalties

Pennsylvania taxable income includes "royalties." *See* 72 P.S. §7303(a)(4).

Royalties are not defined under the Tax Reform Code. However, in *Tygart Resources, Inc. v. Com.*, the Commonwealth Court of Pennsylvania determined that payments received by an S Corporation for the extraction and sale of coal from its coal lands was royalty income under the Personal Income Tax. 578 A.2d 86, 88 (Pa. Commw. Ct. 1990). The Court held that roylaties include payments receieved as "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." *Id.*

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.

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:

- 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;
- 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
- 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.]

For information regarding the Pennsylvania personal income tax treatment of royalties and rents, refer to PA Personal Income Tax Guide - Net Income (Loss) from Rents, Royalties, Copyrights, and Patents.

PENNSYLVANIA PERSONAL INCOME TAX TREATMENT OF TIMBER

The sale of timber can be taxable for purposes of the Pennsylvania personal income tax. Refer to Pennsylvania Personal Income Tax Letter Ruling No. PIT-08-003 for more information.