pennsylvania
DEPARTMENT OF REVENUE

INFORMATION NOTICE
PERSONAL INCOME TAX 2013-04

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Intangible Drilling & Development Costs

Purpose

This notice provides Personal Income Tax ("PIT") taxpayers with guidance on how to recover intangible drilling and development costs associated with oil, gas and geothermal wells.

The notice does not govern the treatment of intangible drilling costs ("IDCs") for Corporate Net Income Tax purposes regardless of whether such IDCs are incurred directly by a corporation or by a partnership with corporate partners.

Effective Date

The rule described in this Informational Notice is applicable to taxable years beginning after December 31, 2013.

Background

Act 52 of 2013 amended section 303 of the Tax Reform Code of 1971 (72 P.S. § 7303) by providing a rule for the capitalization of intangible drilling and development costs ("IDCs") and the amortization of such costs over a fixed period. It also provides for an election to currently expense a portion of IDCs.

Prior to Act 52, a person could not currently expense any IDCs for Pennsylvania Personal Income Tax purposes. Rather, a person was required to capitalize IDCs and recover them through amortization ratably over the life of the well.

IDCs Defined

For Pennsylvania Personal Income Tax purposes, IDCs are those costs properly reported as IDCs for Federal income tax purposes. *See* I.R.C. § 263(c), and the Treasury Regulations thereunder, for costs that qualify as IDCs.

Capitalization and Recovery of IDCs

Pursuant to Act 52, a person is generally precluded from expensing IDCs and instead must capitalize them and recover them through amortization ratably over a 10-year period beginning with the tax year in which they are incurred.

Election to Currently Expense a Portion of IDCs

Act 52 provides for an election to currently expense a portion of IDCs. A person that incurs IDCs 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).

Who Makes the Election?

The person directly incurring the IDCs is the only person eligible to make an election to currently expense up to one-third of the IDCs.

Method of Making Election

The person directly incurring the IDCs shall make the election to expense up to one-third of the IDCs by taking a current expense deduction on his/her tax return. If an individual directly incurs the IDCs, the election is made on his/her PA-40 by simply showing the expense. If a partnership or S corporation directly incurs the IDCs, the election is made on its PA-20S/PA-65 by showing the expense. If the PA-20S/PA-65 is not filed, or no RK-1 is provided, then the IDCs must be amortized.

The election to currently expense a portion of a person's IDCs is not a one-time election. A person may elect each tax year to expense up to one-third of the IDCs that the person incurs during that tax year. A person may also choose not to currently expense any IDCs in a tax year even if the person elected to currently expense IDCs in a prior tax year.

Pass-Through Entity Issues

If IDCs are directly incurred by a partnership or S corporation, such entity, as opposed to its partners or shareholders, is required to decide how to recover such IDCs. The method of recovering IDCs utilized by a partnership or S corporation is binding on and must be followed by such entity's partners or shareholders. If the partnership or S corporation does not make an election to expense the IDCs for Pennsylvania Personal Income Tax purposes, its partners or shareholders must capitalize and amortize their share of the IDCs ratably over a 10-year period beginning with the tax year in which they are incurred.

No Carry Forward of IDCs

IDCs, whether recovered through current expensing or amortization, cannot be carried forward and deducted in a subsequent tax year regardless of whether the taxpayer derives a tax benefit from the IDCs.

When is an IDC Incurred?

For Pennsylvania Personal Income Tax purposes, an IDC is “incurred” when the cost is required to be recorded on the person’s books according to the person’s method of accounting. A cash method taxpayer records an IDC when he/she/it pays such cost. An accrual method taxpayer records an IDC when the cost is fixed and determined, even if not yet paid.

Dry Hole IDCs

Dry Hole IDCs (capitalized IDCs attributable to an unproductive exploratory well) are reported as a Pennsylvania Personal Income Tax Schedule D loss in the year in which the well is determined to be unproductive.

Disposition of Certain Oil and Gas Property

Disposition of the oil and gas related property or entity on which the one-third expensing of IDCs was taken does not require the associated gain from such disposition to be treated as ordinary income for Pennsylvania Personal Income Tax purposes. All amortization and direct expensing of IDCs are adjustments to basis and will be reflected in the determination of the gain or loss on the sale, exchange or disposition of property.

Examples

Example # 1

Jane Taxpayer, an individual, directly incurs $99,000 of intangible drilling and development costs in 2014. She elects to currently expense these costs for Federal income tax purposes. For Pennsylvania Personal Income Tax purposes, Jane Taxpayer has three options:

1. Capitalize the costs and recover $9,900 per year in tax years 2014 through 2023;

2. Expense $33,000 in 2014 and recover the remaining $66,000 in $6,600 per year increments in tax years 2014 through 2023; or

3. Expense less than $33,000 in 2014 and recover the remainder ratably in tax years 2014 through 2023.

Example # 2

Same as Example # 1, except that XYZ Partnership replaces Jane Taxpayer. For Pennsylvania Personal Income Tax purposes, XYZ Partnership has the same three choices as Jane Taxpayer in Example # 1. XYZ Partnership would make this choice by completing its PA-20S/PA-65 accordingly. XYZ Partnership's partners are bound by the decision XYZ Partnership makes and the income as reported on their respective RK-1s/NRK-1s will already reflect their share of IDC deductions.

Example # 3

Same as Example # 2, except that ABC Partnership, a Delaware partnership with no PA-source income, replaces XYZ Partnership. For Pennsylvania Personal Income Tax purposes, ABC Partnership has the same three choices as XYZ Partnership in Example # 2. ABC Partnership would make this choice by completing a PA-20S/PA-65. If ABC Partnership chooses not to file a PA-20S/PA-65, ABC Partnership's partners are required to recover their share of ABC Partnership's IDCs ratably in tax years 2014 through 2023.