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TAX ADVANTAGES OF OIL AND GAS PARTNERSHIPS

OIL & GAS PARTNERSHIPS

EVERY TEXTBOOK STATES THE SAME THING AT THE BEGINNING:

"The taxation of natural resources is one of the more complicated areas of the U.S. federal income tax system."

AND THEY ARE NOT KIDDING!

OIL & GAS PARNTERSHIPS

However, don't be disappointed: Unless your client has a **direct ownership and management of oil and gas properties**, accounting and taxation of oil & gas is relatively simple.

The remainder of this class is going to focus solely on dealing with issues that may be presented on schedules K-1 for limited partners in oil and gas limited partnerships.

The complete handling of oil and gas issues requires a college level course spanning 16 weeks or more.

Oil & Gas Partnerships

The easiest way to begin this presentation is that you must first understand that your client **must be a limited partner in an oil and gas limited partnership**. This is easy to determine. Under Part II, Line I, the box for "Limited Partner or other LLC member" will be checked and Line K of Part II will indicate a limited partner. See copy of K-1.

If either one of these boxes is not checked, your return preparation has just become extremely difficult and is beyond the scope of this presentation.

Items you can expect on a Schedule K-1 from an oil & gas limited partnership interest

Royalty Income – Generally, the owner of a productive oil and gas interest will not receive royalty income because they are the owners of the well and will be paying the landowner the royalty.

Rather, they will have Schedule K-1 Ordinary income and loss because they are operating a business (assuming the partnership has a “working interest” in the oil or gas well).

Items you can expect on a Schedule K-1 from an oil & gas limited partnership interest

Interest Income – as the partnership will be holding cash from its investors almost all partnerships will show some type of investment income. This is simply entered onto the Schedule B.

Items you can expect on a Schedule K-1 from an oil & gas limited partnership interest

Intangible Drilling and Development Costs – Because of the high risks involved in drilling exploratory and developmental wells, taxpayers are allowed to make a binding one-time election to expense intangible drilling and development costs (“IDC”) This election allows taxpayers an immediate write-off of expenditures that would otherwise be capitalized and amortized. We are not going to go into what constitutes IDC but just tell you that it exists and how to handle it on the form 1040. ***<u>This election is made at the partnership level.</u>***

Items you can expect on a Schedule K-1 from an oil & gas limited partnership interest

IDC is also an item of tax preference – the K-1 should also have a line item called "Excess Intangible Drilling Costs" that will contain a number that is to be entered onto form 6251. In general, the preference amount is equal to 65% of the difference between the "Excess Intangible Drilling Costs" and "net income from oil and gas properties". The calculation of excess intangible drilling costs is beyond the scope of this presentation. Your software program should walk you through this input.

Items you can expect on a Schedule K-1 from an oil & gas limited partnership interest

Depletion – this is the oil and gas equivalent of depreciation and represents the use of the in place minerals.

It comes in two varieties – percentage and cost depletion. Each is calculated in a separate fashion.

Items you can expect on a Schedule K-1 from an oil & gas limited partnership interest

Cost Depletion – This is a cost recovery system based upon the number of units produced and sold during the year in relation to the total estimated recoverable reserves.

Percentage Depletion – In general this amount is equal to 15% of the "gross income from the property". This amount is further limited in that the depletion allowance cannot exceed 65% of the taxpayer's taxable income for the year computed without regard to the depletion allowance or any net operating loss carryovers or carry backs.

Both of these amounts, cost and percentage depletion, will be provided on the Schedule K-1 as separate line items.

Cost or Percentage Depletion

Each partner will be permitted to elect whether he will use cost or percentage depletion. Further the determination as to whether to use cost or percentage depletion is determined on a property by property basis and on a year by year basis. You cannot claim both percentage and cost depletion on the same property in the same year.

Thus a taxpayer may use percentage depletion on property A in year one and cost in year two. Obviously, unless there are other compelling reasons, use the deduction that generates the greatest amount of deduction.

Percentage or Cost Depletion

Alternative minimum tax – The excess of the percentage depletion deduction over the adjusted basis of each property at the end of the taxable year (determined without considering the depletion deduction for the taxable year) is an item of tax preference. These amounts will be set out for you on the Schedule K-1 as separate line items.

Items you can expect on a Schedule K-1 from an oil & gas limited partnership interest

Self Employment Income – interestingly, income or loss, including the amount of the IDC, is added to or subtracted from self employment income on schedule SE. Be sure to enter these amounts as they are set forth on the K-1s.

Closing Remarks

If you are confused about something, do not hesitate to call the preparer of the return or the oil or gas partnership itself. They generally will be very helpful. If you see a client with an oil or gas K-1, set aside some time and review it carefully before diving into the preparation. Make sure you leave time to call the preparer or partnership and obtain an appropriate response.

Thank you for attending!