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Natural Gas Income and Federal Income Tax

Tax season will be especially worrisome this year for landowners who may have received natural gas lease payments during 2008. Below is a brief summary of federal income tax items for individuals who received natural gas lease bonus income in 2008. Please consult with your tax preparer and/or financial advisor or visit www.irs.gov to help you through this complicated process. Consulting a financial professional about the potential tax implications can save you hundreds and even thousands of dollars.

Lease payments or bonus payments and royalty income from gas and oil production are considered ordinary income for federal income tax purposes. As a landowner who received natural gas income during 2008, you should receive a 1099 from the leasing company for reporting purposes. This income should be reported on form 1040 Schedule E.

Tax is owed on any lease/bonus payments received in the tax year they are received, regardless of the length of the lease. For instance if you received a lump sum payment of $500 per acre for a 5 year lease during 2008, you owe federal income tax on entire payment in the 2008 tax year. If, however, the leasing company is paying you $100 per acre each year for 5 years, you only owe federal income tax on the amount received each year.

You may deduct those expenses from your lease or bonus payment you paid or incurred during the taxable year that were directly attributable to your execution of a lease contract. Examples would include attorney fees, surveying costs and fees incurred for deed research.

Net royalty income from oil and gas production can be reduced for federal income tax purposes by the *greater of* a cost basis deduction or a percentage depletion allowance. Unless a landowner allots some of the purchase price of his land to oil and gas deposits, there is no cost basis assigned to oil and gas that may be produced. For the lessor, the percentage depletion allowance is limited to 65 percent of taxable income for the year. The depletion allowance for oil and gas is 15 percent. The depletion allowance cannot exceed 100% of the actual taxable income from the property before the depletion deduction.

For example, a lessor/landowner has $10,000 of royalties, taxable income from the oil and gas property of $9,000 and total taxable income of $30,000. The tentative depletion allowance is $1,500 (15% of $10,000). The taxable income limitation is $9,000 (100% x $9,000) and the overall taxable income limitation would be $19,500 (65% x $30,000). Neither limitation is a factor in this example, so the depletion deduction would be $1,500. In this example, there was no cost basis for newly discovered oil and gas, so the cost basis deduction is zero. Thus the depletion allowance, as calculated, would be the applicable deduction—$1,500 in this example.

Estimated tax is the method used to pay tax on income that is not subject to withholding, such as income from a natural gas lease on your property. If you do not pay enough through withholding or estimated tax payments, you may be charged a penalty. If you do not pay enough by the due date of each payment period you may be charged a penalty even if you are due a refund when you file your tax return.

If you had a tax liability for 2007, you may have to pay estimated tax for 2008. You must pay estimated tax for 2008 if both of the following apply.

1. You expect to owe at least $1000 in tax for 2008 after subtracting your withholding and credits.
2. You expect your withholding and credits to be less than the smaller of;
   - 90% of the tax to be shown on your 2008 tax return, or
   - 100% of the tax shown on your 2007 tax return. Your 2007 tax return must cover all 12 months.

For estimated tax purposes, the year is divided into four payment periods. Each period has a specific payment due date. If you do not pay enough tax by the due date of each of the payment periods, you may be charged a penalty even if you are due a refund when you file your income tax return.

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Information adapted from “Negotiating Oil and Gas Leases on Indiana Farmland”, Perdue University and www.irs.gov.