Tax Break for Landowners Who Receive Royalty Income

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As many natural gas wells begin to produce royalty income for their owners, the attention of some should shift to potential income tax benefits which may not be apparent. Royalty owners can take an income tax deduction from federal taxable income for a portion of their royalty income on account of natural gas royalties attributable to gas produced from their property. This tax break is known as the “Percentage Depletion Allowance” and it can provide significant benefits, reducing taxable income and your federal income tax bill. Generally, the allowance is equal to 15% of the income produced by your leased property. It is subtracted when calculating the income from that property that you will report on your tax return. An allowance may be available for partial interests as well. For instance, if you own a 50% interest in the property, your allowance would generally be calculated on 50% of the property’s gas production. Several limitations apply and are discussed below.

The first limitation is based on average daily production (yearly production ÷ 365) and is basically a cap on the amount of gas production that can be used in figuring your depletion allowance. If the average daily production of your property is more than 6 million cubic feet of gas, this limitation will kick in. Only the income produced by the equivalent of 6 million cubic feet of gas per day will be considered (a specific calculation is used when this limitation applies). On an annual basis the limitation will kick in at production of about 2.190 billion cubic feet over twelve months. Based upon current production patterns, this limitation may apply to the first year of production.

A second limitation prevents claiming a deduction which exceeds the taxable income from the property. Limitations are applied on a per property basis so individual gas producing properties need to be considered. Those properties that produce better than others cannot be lumped together to increase the base upon which the allowance is computed. Additionally, the deduction cannot be greater than 65% of all of your taxable income from all sources. Think of taxable income as your gross income minus your deductions and personal exemptions. With that in mind, this limitation only comes into play when royalty income is very high.

A deduction for percentage depletion is not allowed for lease bonuses, advance royalty payments, or other amounts payable without regard to actual production. In other words, the allowance will not include a 15% share of your signing bonus. The allowance is not available to certain types of retailers and refiners. For typical landowners though, this limitation will not apply.

Here is a very simple example. Let’s say your property produced less than 6 million cubic feet of gas per day in 2010 and you received $100,000 in royalty payments. The depletion allowance would essentially reduce that $100,000 to $85,000 on your tax return ($100,000 reduced by 15%). You would be taxed on $85,000 rather than $100,000. If you had $60,000 in taxable income from other sources, the depletion allowance could save you $3,849 in taxes, depending on other circumstances. Of course, this is a very simplified example and you should feel free to contact us or your income
tax professional if you would like to talk about your specific situation. Our goal in this Alert is merely to make you aware that this tax break exists.

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