

#### **4. The Economic, Legal, and Tax Implications of An Oil Lease**

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#### **Abstract/Summary**

*South-central Kansas has experienced a recent boom in the amount of land being leased for oil and gas production. New horizontal drilling techniques have made the area very attractive to the major oil companies. This interest seems to be spreading throughout much of Kansas.*

*In this session, we will discuss the types of leases you may encounter in terms of bonus payments and royalty percentages. We will also cover the significant legal provisions you should consider to be included in your lease to protect against damages to farm land, cattle grazing issues, and surface water rights.*

*Finally we will give you an overview of the income tax implications of an oil and gas lease bonus payment and the royalty interest you may derive from production if the drilling is successful*



## PURPOSE OF THIS SESSION

- Review the tax issues related to the lessor in oil & gas lease and production agreements.

## Royalty Income

- Passive Income – not subject to Self-Employment tax
- Royalties are not subject to the earnings test for determining eligibility for drawing social security before full retirement age.
- Percentage depletion is available on royalty income and is equal to 15 percent of gross income.

## Lease Bonus Payment

- Treated as an advance royalty
- Ordinary income
- Not subject to percentage depletion
- May be subject to cost depletion
- IRS 1099 should reflect the lease bonus in Box 3 – royalty income, but this is real inconsistent among oil leasing companies.

## Section 1031 exchanges

- Royalty interests, working interests, and overriding royalty interests are all interests in real property, thus are eligible for Section 1031 treatment. Recapture depreciation and IDC.
- This applies to sales only, if you retain a non-operated interest, the consideration cannot be reinvested in a 1031 exchange.
- Be careful of inquiries looking to buy your entire mineral interest – you are giving up all rights to potential oil & gas production.

## Cost Depletion Issues

- Did you carve out a mineral rights value when you acquired the property?
- What are the total estimated reserves and revenue for the lease acres?
- Possibly could use an estimated reserve curve, instead of an individual reserve report.

## Cost Depletion Example

- Joe Farmer bought 160 acres in 2010 at a public auction where the minerals were sold separately from the surface rights. He paid \$ 500 per acre for the minerals and \$ 1200 per acre for the land, for a total of \$ 1700 per acre.
- Sandridge offers Joe a 3 year lease with a bonus payment of \$ 400 per acre and a 3/16 royalty. The estimate reserve value is \$ 1200 per acre.
- Cost depletion is calculated by dividing the \$400 lease bonus by the total income of  $(400+1200= 1600)$  or 25%. 25% of the mineral rights basis of \$ 500 equals \$ 125 per acre cost depletion. Joe reports the \$ 400 bonus payment less \$ 125 of cost depletion.

## Cost Depletion Issues

- Collums v. US allowed 100 percent of cost depletion on lease bonus payment.
- The taxpayer is saying that there are no reserves in order to take 100 percent cost depletion, so the fact that a lessee is offering bonus payments contradicts the taxpayer.
- IRS says that it is aggressively pursuing any taxpayer who uses 100 percent cost depletion.

## Farm Tax Planning to Offset Lease Bonus Income

- Lease bonus is passive income, so you cannot use Section 179 on equipment purchases to create a loss on the farm to offset oil bonus payments.
- Bonus depreciation on new equipment purchases can be used to generate a farm loss. Bonus depreciation was 100 % in 2011 and is 50% in 2012.

## 2012 Marginal tax rates Married Filing Jointly

- 0-17,400            10 %
- 17,400-70,700    15 %
- 70,700-142,700   25 %
- 142,700-217,450 28 %
- 217,450-388,350 33 %
- 388,350 and above 35 %
- Kansas top rate    6.45%

## Crop Damages

- Ordinary income reported on Schedule F

## Easements/Water Sales

- Permanent easements are a capital sale of land and is eligible for capital gain treatment.
- Only the acres subject to permanent easement can use the cost basis to reduce gain (30' easement for ½ mile is approx 2 acres)
- Temporary easements are ordinary income, but not subject to SE tax.
- Water sales are ordinary income.

## Drilling Mud Disposal

- KCC regulates what product can be spread on farm fields.
- Recommend get a lab analysis before allowing drilling mud to be spread on your fields.
- Horizontal wells to 4000 feet are paying around \$ 4000 per well to spread drilling mud.
- Income from disposal of drilling mud is ordinary income

## Royalty Associations

- Southwest Kansas Royalty Owners Assoc  
swkroa.com
- Eastern Kansas Royalty Owners Assoc  
ekroa.com
- You may want to consider participation in these associations to give yourself some representation in legislative matters.