The Taxing Issues of Gas Wealth

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Close to 100 people braved the bitter cold to attend an educational session about "Financial Considerations of the Natural Gas Rush" at Tioga Central Middle School on February 2. The Tioga County Landowners Group hosted the discussion of income tax considerations and estate planning implications related to wealth generated by future gas production.

CPA Deborah Bernardo presented an audio-visual PowerPoint presentation created by her colleague Jim Leonard, CPA. The program began with a review of lease basics with emphasis on primary and secondary terms of rent and royalties. While many people focus on the rent – how much money a company will offer to lease your land – Leonard's message was that the real money is in royalties.

Using a typical cartoon family – the "Flintstones" – the slideshow illustrated some of the tax liabilities that occur when one receives large amounts of money. Leonard based his figures on a typical family with an income of $50,000/year (the national average). Taxes on that income would be close to $5,750.

If this family leased 200 acres to a gas company at $2,500/acre, an amount that was offered in some regions of the Southern Tier last summer, they would receive $500,000 in rents. Added to their annual income, they'd see a total yearly income of $550,000. Their income tax would jump to $197,000 (for married, filing jointly).

Then there's the royalties. A well producing 1,000 thousand cubic feet (mcf) of natural gas per day can generate a fair amount of income. Assuming a 15 percent royalty, and that the land made up half the drilling unit, Leonard estimated that his stone-aged family might earn $1.8 million in a year off royalties alone.

Calculating taxes on royalties is different, Leonard told *Broader View Weekly* in a phone interview later in the week. "There's a percentage depletion, which means that you're not taxed on the first 15 percent of the royalty income you receive." So Leonard figured that his "typical" family would owe another $65,000 in taxes on their royalty income.

"Much of the income associated with gas production is subject to tax," Leonard said. He listed rent, royalties, advance royalties, delay rentals, shut-in royalties, and well pad location fees. Leonard stressed that with the layers of potential gas-bearing strata, landowners may be looking at many years of gas production on their land.

Bernardo emphasized the need to pay attention to details, such as submitting estimated tax payments. Many people think that they're tax liability is covered by whatever taxes are withheld from their paycheck, Bernardo said. But when you gain a large amount of unexpected wealth, such as a check for a bonus payment on a gas lease, the amount withheld will not cover all the taxes you owe. She urged people in such a situation to obtain professional financial help.

What happens if you receive a lease check in December of 2008 and don't cash it until 2009? You still owe taxes on that income for 2008. Not only that, if you received a huge bonus and invested it in the stock market, then lost it when the market fell – you still owe taxes on the original income.

A number of landowners asked about valuing land in determining estates. Others wanted to know how property was assessed and what effect leases or ownership of mineral rights had on its valuation. Bernardo could not answer definitively, saying "This is something that is still being tested."

A number of questions were raised about the tax benefits of various lease structures. For example, a landowner may prefer to receive his lease payments in equal annual installments over the life of the lease. Nick Schoonover, hosting the meeting for the Tioga County Landowners Group, explained that another coalition structured a payment schedule that increased rent payments each year: $250/acre the first year, $350 the second, and so on.

Leonard cautioned that landowners need to read their leases carefully. While you are taxed on the income you receive, under the "doctrine of constructive receipt" a taxpayer may owe for income they may have elected to receive in the future. This would happen when a landowner is offered the right to choose whether to receive the entire payment up front or receive it in installments, Leonard clarified.

Because there are unexpected taxes that accompany sudden gas wealth, Leonard reiterated his suggestion that people talk to their accountant or financial advisor. "A lot of people have never needed an accountant before," he said, "but this sudden change in their financial circumstances makes it worthwhile."

Leonard's presentation touched briefly on estates, trusts, gifts and charitable giving. Because so many people raised questions about these issues, Leonard has arranged to offer another seminar focusing on those topics later in the spring. "After tax season," he said.