Gas Wells Promise Wealth and Taxes

by Sue Smith-Heavenrich

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Tioga County landowners gathered in the Candor High School auditorium on Tuesday, December 15 for an update on lease issues and to learn more about wealth management. Given that lease rents and negotiated royalties have increased over the last year, CPA Jim Leonard suggested that landowners take the time to learn about financial issues that apply to oil and gas leases.

Earlier in the year XTO closed a deal with Deposit landowners that offered a little over $2400/acre and 15 percent royalties. Then last week Exxon said it would acquire XTO for the sum of $41 billion. What this means for local landowners is that larger companies are interested in Marcellus, and that interest may push lease offers even higher.

Given that landowners may suddenly see a lot of extra cash in their bank balance, Leonard offered some words of advice. First, he reminded landowners to keep their focus on the royalties. “People hear $5500/acre and think it’s a deal,” he said. “But the real return on your investment is the royalties.” Once the well is in and the gas is being pumped out, the rental checks cease. So it’s worth giving up a bit of money in the lease rent to gain a higher percent royalty.

Income Taxes

Whether the income is in rent checks or royalty, the income could be significant, and Leonard warned people to pay attention to income taxes. Most of the income falls under “ordinary” income, not capital gains. This includes reimbursements and payments for damages to crops and timber. Even the royalties are treated by the IRS as ordinary income.

For some people the increase in income will push them into the highest tax bracket of 35 percent. For everyone, a significant increase in income will mean making quarterly tax payments on estimated income taxes – even for farmers who usually file taxes only once a year, Leonard emphasized. “Before you lease, talk to your accountant,” he said. If you pay too little in estimated taxes you will owe penalties and interest. Estimating taxes on gas income is made more difficult because well production fluctuates from year to year.

Get an accountant, Leonard advised. “What you save in penalties and interest will easily pay for his services,” he said. “And make sure you put half of your income aside for those taxes,” Leonard added. Even if you invest in the stock market and lose your money, you have to pay taxes on the income you earned.

One of the hardest things to swallow is the fact that if you take your lease payments over time, so much a year, the IRS will tax the entire amount as a lump sum payment on the first year.

Leonard then showed landowners how to calculate their royalty rate from their interest in a well. This is important to know because at the end of the year the gas company sends out 1099s with the income listed. Landowners should only see rents (box 1) and royalties (box 2) – unless they are participating well owners. Amounts listed in any other box will trigger self-employment taxes

Severance & Property Taxes
Almost every other state where gas and oil are extracted has some sort of severance taxes, Leonard said. Texas levies a 7.5 percent tax on volume removed from the ground while Louisiana receives 33 cents per unit of gas. Unfortunately, income from severance taxes doesn't seem to make it back to the communities where the gas wells are, Leonard said. In Louisiana the roads are in terrible condition because of the drilling traffic; many of those communities are fighting to get severance tax monies returned to them so they can repair their roads.

"It's when you look at property issues that things get ugly," Leonard said. Nothing is definitive yet regarding how gas development will affect local property taxes, and town assessors are waiting for the state to clarify the rules. One thing that might happen is that property taxes may be raised for everyone, even if landowners in an area are against drilling and have not leased their land.

Another alternative is a production tax that would be paid by the gas company. At this time there is not a lot of case law on taxing issues, and Leonard suggested that a good lease would clarify that extra taxes be borne by the gas company.

One of the loopholes in the gas tax issue is that the state Office of Real Property Services (ORPS), town assessors and DEC all depend on production reports that come from the gas company. There is no one auditing these numbers, Leonard said. With such self-reporting the playing field is tilted in favor of the gas company, and the tax burden comes back to the landowner.

Industry analysts claim that gas exploration will bring economic benefits, Leonard said. But where does the money really go? One study of the Haynesville deposit in northeastern Louisiana noted that $3.9 billion in economic gain was generated in 2008. Of that, Leonard said $3.2 billion came from royalties and lease payments. The gas industry also claimed that they crated 32,745 new jobs with drilling and related activities. But only 430 of those were employees or contract workers directly involved in the gas industry.

The point Leonard tried to make was that while some landowners would see an increase in their wealth, the increased demands for services would put an increased demand on town budgets. Towns would receive little return in gas monies and the result would be higher property taxes for everyone in the town.

You can read additional coverage on this issue in *The Taxing Issues of Gas Wealth*, originally published Feb. 13, 2009 and archived at http://www.tiogagaslease.org/images/BVW_02_13_09.pdf