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Oil and Gas Tax Deductions Recap

The Tax Reform Act of 1986 introduced the concept of "passive" income and "active" income. The act prohibits the offsetting of losses from passive activities against the income from active businesses. The Act provides that a working interest in an Oil and Gas drilling program is not "passive" activity. Accordingly, deductions can be offset against income from business income, salaries, and other "active" income (see section 469(c)(3) of the Tax Code).

1. Following a successful oil and gas investment, the IRS allows for a tax write-off against an investor's taxable, earned income of approximately 65% - 80% of the investment amount in the first year as "Intangible Drilling Costs (IDC's). In addition, about 20% - 35% of one's investment amount is allocated to "Tangible Drilling and Completion Costs (TDC's)". TDC's are depreciated over a seven-year period, or accelerated through bonus depreciation (section 168(k) of the Tax Code). Bonus deprecation allows a first year depreciation deduction of 60% of the TDC's in 2024; it lowers to 40% in 2025, and 20% in 2026. After 2026 the rules revert back to being spread out over 7 years.

2. In the case of an unsuccessful investment, the IRS allows nearly 100% of the investment to be written off against an investor's taxable, earned income. This differs greatly from stock investments, where only a small portion of the capital loss may be written off (subject to certain limitations).

3. Small/Independent Producers Tax Exemption – Depletion Allowance: The IRS allows 15% of an investor's income from Working Interest Income in oil and/or gas producing property to be "tax free" (known as depletion allowance). Subject to certain limitations, see section 613A of the Tax Code.

4. Net profits from producing oil and gas wells is paid monthly. Therefore, each check serves to reduce the amount initially invested. This also differs greatly from stock investments, where realized gains are future pending from the one-time sale of stock.

5. Most importantly, an accredited investor, who will generally have the highest federal tax rates, investing in oil and gas projects can greatly reduce their tax liability (see the example at the end).

These tax benefits are not found in stocks, real estate, or any other investment.

Summary:

a. 65%-80% of the initial investment is classified as "Intangible Drilling Costs" (IDC's) and may be written off against ordinary income in the year of investment.
b. 20%-35% of the initial investment is allocated to "Tangible Drilling and Completion Costs" (TDC's), and may be written off against ordinary income across a 7-year period, or accelerated through bonus depreciation in the first year.
c. Lease operating expenses (LOEs), which entail the daily costs of an operational well, are generally deductible in the year incurred, without any AMT consequences.
d. Income from oil & natural gas is subject to the 15% tax free depletion allowance, subject to certain limitations.

Simplified Example of Year 1 Tax Deduction for Oil and Gas

Intangible Costs:		
Capital Contribution	$100,000	
IDC's	at 75%	
Intangible Expenses Deduction	**$75,000**	
Tangible Costs:		
Capital Contribution	$100,000	
Tangible Equipment Costs	at 25%	
	$25,000	
*Bonus Depreciation at 60% (for 2024)	$15,000	
Year 1 Tangible Deduction	**$15,000**	
First year reduction in taxable income:		**$90,000**
Tax Bracket		at 37%
Real Dollar savings from tax benefit:		**$33,300**

*See #1 above for information on section 168(k) bonus depreciation. The remaining portion is then depreciated over the remaining 6 years.

Note: The information provided is for educational purposes only and does not constitute tax advice. We recommend that all investors consult with their tax advisors to ensure their investment decisions comply with current tax laws.

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