

#8: Oil and Gas Investments

When the NIIT is taken into account, income tax rates could be as high as 40.8% on ordinary income and short term capital gains and as high as 23.8% on long term capital gains. This makes smoothing income to avoid the high tax brackets extremely important. In general, there are two ways to avoid having taxable income in a higher tax bracket. One is by taking income from an unusually high-income tax year and spreading it over several tax years. Two of the key strategies for doing this are charitable remainder trusts and installment sales. The other is by creating large deductions or credits in the high-income year. Perhaps the best way to create a large deduction in a tax year is with oil and gas investments.

Intangible Drilling Costs

Congress created important tax incentives to encourage domestic oil and gas production. Investors can deduct 100 percent of their share of intangible drilling costs (IDCs) in the year they are incurred. IDCs are those expenses that have no salvage value even if the well later turns out to be dry. They include expenses for labor, drilling rig time, drilling fluids, removing the oil rig, plugging the well if it is dry, and surface and crop damage to landowners. IDCs typically produce deductions equal to 65 to 85 percent of the total investment. Thus, a \$100,000 investment could produce an immediate deduction of \$65,000 to \$85,000. Investors ordinarily pay these amounts before drilling begins, but the costs are deductible in the current year provided that drilling begins by March of the following year. Moreover, the deduction is available regardless of whether the well strikes oil.

Under the special rule of IRC § 469(c)(3), a working interest in an oil or gas well is not a passive activity, regardless of the taxpayer's participation in the activity, unless the taxpayer holds the interest through an entity that limits the taxpayer's liability. For this purpose, liability is limited if the taxpayer holds a limited partnership interest, stock in a corporation, or an interest in an entity that, under applicable state law, limits the potential liability of a holder of such interest to a determinable fixed amount.²² If a taxpayer has both limited and general partner interests in an oil and gas partnership, the total interest is treated as non-passive.²³

The deduction can be used to offset active income from wages, interest, business profits, or capital gains. This can produce large tax savings as the following example illustrates.

Example 1. Carl is a single taxpayer who expects taxable income of \$100,000 – all ordinary income – in 2024 absent selling any assets. However, consider that he sells X Corporation stock, with a basis of \$100,000, for \$500,000, recognizing a long-term capital gain of \$400,000. The first \$100,000 of gain is taxed at 15%, the next \$292,300 of gain is taxed at 18.8%, and the remaining \$7,700 of gain is taxed at 23.8%, as shown in the following chart:

²² Reg. § 1.469-1T(e)(4).

²³ *Id.*

	Capital Gain Tax Rate	Tax Payable
First \$100,000 of gain	15%	\$15,000
Next \$292,300 of gain	18.8%	\$54,952
Last \$7,700 of gain	23.8%	\$1,833

Now suppose Carl re-invests the proceeds from the sale, about \$375,000 say, in an oil and gas partnership that produces \$50,000 of income each year from 2022-2026. However, this investment also produces a tax deduction of \$300,000 in 2022, assuming 80% of the investment is deductible intangible drilling costs (.8 x \$375,000).

This deduction would first eliminate all of Carl’s \$100,000 of ordinary taxable income taxed at 22%, 12%, and 10%. Then it would begin to reduce capital gains. On net, Carl would go from having \$100,000 of ordinary income and \$400,000 of capital gain to merely \$200,000 of capital gain subject to taxation. \$41,776 of this capital gain would be subject to a 0% rate and \$158,224 would be subject to a 15% rate for a total tax bill of just \$23,734.

According to IRS Publication 535, a taxpayer elects to deduct IDCs as a current business expense by taking the deduction on Form 1040 for the first tax year the taxpayer has eligible costs. Furthermore, no formal statement is required. If a taxpayer files a Schedule C (Form 1040), enter these costs under “Other expenses.”

Part II Expenses		Enter expenses for business use of your home only on line 30.					
8	Advertising	8		18	Office expense (see instructions)	18	
9	Car and truck expenses (see instructions)	9		19	Pension and profit-sharing plans	19	
10	Commissions and fees	10		20	Rent or lease (see instructions):		
11	Contract labor (see instructions)	11		a	Vehicles, machinery, and equipment	20a	
12	Depletion	12		b	Other business property	20b	
13	Depreciation and section 179 expense deduction (not included in Part III) (see instructions)	13		21	Repairs and maintenance	21	
14	Employee benefit programs (other than on line 19)	14		22	Supplies (not included in Part III)	22	
15	Insurance (other than health)	15		23	Taxes and licenses	23	
16	Interest:			24	Travel, meals, and entertainment:		
a	Mortgage (paid to banks, etc.)	16a		a	Travel	24a	
b	Other	16b		b	Deductible meals and entertainment (see instructions)	24b	
17	Legal and professional services	17		25	Utilities	25	
				26	Wages (less employment credits)	26	
				27a	Other expenses (from line 48)	27a	
				b	Reserved for future use	27b	

