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INDIVIDUAL INCOME TAX – ELIMINATING THE INCOME AND EXPENSES OF PRODUCING OIL AND GAS

(Replaces Revenue Administrative Bulletin 2001-5)

Pursuant to MCL 205.6a, a taxpayer may rely on a Revenue Administrative Bulletin issued by the Department of Treasury after September 30, 2006, and shall not be penalized for that reliance until the bulletin is revoked in writing. However, reliance by the taxpayer is limited to issues addressed in the bulletin for tax periods up to the effective date of an amendment to the law upon which the bulletin is based or for tax periods up to the date of a final order of a court of competent jurisdiction for which all rights of appeal have been exhausted or have expired that overrules or modifies the law upon which the bulletin is based.

RAB 2018-8. This Revenue Administrative Bulletin (RAB) replaces RAB 2001-5 and discusses the elimination of oil and gas income and expenses as it relates to Part 1 of the Michigan Income Tax Act, commonly known as the Individual Income Tax.

BACKGROUND

The Michigan Severance Tax Act[1] levies a tax on each producer engaged in the business of severing oil or gas from the soil in Michigan. The tax, which is levied on the gross market value at the time of severance from the soil, is levied "in lieu of all other taxes, state or local, upon the oil or gas, the property rights attached thereto or inherent therein, or the values created thereby."[2] This language was historically interpreted as exempting oil and gas income from tax in Michigan, including the individual income tax.[3]

In *Elenbaas v Dep't of Treasury*,[4] the Michigan Court of Appeals examined that exemption under the provisions of the Michigan Income Tax Act. Among the contested issues in that case was the calculation of the amount of the exemption. Treasury argued that the taxpayer must eliminate the

[1] MCL 205.301 *et seq.*
[2] MCL 205.315.
[3] *Cowen v Dep't of Treasury*, 204 Mich App 428 (1994); *Bauer v Dep't of Treasury*, 203 Mich App 97 (1993).
[4] *Elenbaas v Dep't of Treasury*, 231 Mich App 801 (1998).

expenses related to oil and gas production to calculate the net amount of income exempt from tax. The Court, however, rejected Treasury's argument based upon its finding that the severance tax was levied on gross income rather than net income. Thus, taxpayers were permitted to eliminate only the oil and gas income included in federal adjusted gross income without regard to the related expenses of production. In other words, the court concluded that the oil and gas income was exempt from Michigan income tax, but taxpayers could still deduct expenses related to that exempt income.

In 2011, PA 38 was enacted which included amendments to the calculation of Michigan taxable income. The legislature codified the severance tax exemption and clarified that expenses were also required to be eliminated. Specifically, MCL 206.30 was amended to require an adjustment to federal adjusted gross income as follows:

> (1)(w) For tax years beginning after December 31, 2011, eliminate all of the following:
>
> (*i*) Income from producing oil and gas to the extent included in adjusted gross income.
>
> (*ii*) Expenses of producing oil and gas to the extent deducted in arriving at adjusted gross income.

Oil and gas is defined to mean "oil and gas that is subject to severance tax under 1929 PA 48, MCL 205.301 to 205.317." Thus, PA 38 overturned the holding in *Elenbaas* with regard to the elimination of expenses in computing Michigan taxable income.

Beginning with the 2012 tax year, taxpayers calculating Michigan taxable income are required to eliminate income *and* expenses for oil and gas production to the extent included in federal adjusted gross income. Income and expenses are eliminated from federal adjusted gross income by using Michigan Form *Schedule 1 Additions and Subtractions*. Oil and gas income is eliminated through a subtraction from income; oil and gas expenses are eliminated through an addition to income. To allow for a full review of both income and expenses eliminated on the return, taxpayers must report oil and gas income and expenses separately and should not report only a net elimination amount on the return. The example in Section VII of this RAB illustrates how income and expenses should be eliminated on the Michigan return.

ISSUES

I. Who is required to eliminate oil and gas income and expenses?

i. Ownership Interests

There are several common types of ownership interests used in the oil and gas industry. Federal treatment of both income and expenses under the Internal Revenue Code (IRC) may vary depending on the type of ownership at issue. A basic summary of these interests is imperative to

understanding the types of oil and gas income and expenses that must subsequently be eliminated on the Michigan return.

All interests in oil and gas production first begin with land that has the potential for production. The fee simple owner of such land also owns the separate right to any mineral deposits, including any oil and gas reserves, on or below the soil and may choose to develop or dispose of those mineral rights. For example, a landowner may sell the mineral rights to the property outright. An outright sale of the mineral rights gives the purchaser the right to all revenue and costs resulting from production from the property. The landowner likely recognizes long-term capital gain on the federal return from the sale of mineral rights in any land.

Instead of selling the mineral rights outright, a landowner could instead lease the underlying mineral rights in the land. Where the mineral rights of the land are leased, the lessee acquires a "working interest" (or operating interest) in the mineral rights of the land. The working interest holder will explore, develop, and bring the land to production in exchange for a residual share of all resulting production revenues. That is, the holder of a working interest is burdened with all of the costs and expenses of development, exploration, and operation of the property. In addition, the working interest may be subject to transactional leasing costs, such as an upfront bonus payment, as consideration for the lease and "delay rental" payments for periods where drilling has not yet commenced on the land.

The working interest is typically subject to any retained royalty interest of the landowner called a "fee royalty interest." A fee royalty is "compensation or portion of the proceeds paid to the owner of a right, as a patent or oil or mineral right, for the use of it."[5] A landowner holding a fee royalty interest is entitled to receive a share of all production of the land in perpetuity. Typically, a fee royalty interest is equal to 1/8 of all oil and gas severed from the property, though it may vary based on the terms of the operating agreement. The royalty is paid to the landowner free of any costs and expenses of production or other development costs.

Both fee royalty interest and working interest holders may, subject to the terms of any lease agreement, sell or dispose of their interest in the production revenue of the property. These subdivisions create additional interests in the mineral rights. For example, an "overriding royalty interest" allows for the right to participate in the working interest's share of production pursuant to its lease with the landowner. An overriding royalty interest is not an interest in the underlying minerals, but only a right to share in the revenue owed to the working interest pursuant to the lease. It does not affect the owner of the mineral rights, and its interest remains operative only to the extent the underlying lease is operative. The overriding royalty interest is not burdened with any expenses related to producing oil and gas.

The above-described ownership interests may be held individually or by flow-through entities that distribute a share of income and expenses to individual shareholders. Owners and shareholders of these flow-through entities will receive a share of income and expenses based upon that entity's working or royalty interest in Michigan production property. To the extent an individual taxpayer receives all or any portion of income which relates to the royalty or working interest of the flow-

[5] *Mobil Oil Corp v Dep't of Treasury,* 422 Mich 473 (1985).

through entity, the taxpayer must eliminate the related income and expenses. Generally, any oil and gas income received from a flow-through entity will be reported to an individual taxpayer on a federal Schedule K-1.

ii. Location of Wells

MCL 206.30(1)(w) requires the elimination of all income and expenses related to producing oil and gas. Oil and gas is defined in the Michigan Income Tax Act to include only "oil and gas subject to severance tax under 1929 PA 48, MCL 205.301 to 205.317." The tax imposed under the Michigan Severance Tax Act is levied only on oil and gas wells located in Michigan. Therefore, elimination of any income and expenses is only permitted to the extent the income and expenses result from the operation of Michigan wells. For income and expenses that cannot be attributed to the operation of one particular well, such as administrative and financial overhead, taxpayers may apportion those items across all wells.[6] Other income and expenses that can be directly attributed to a Michigan well must be eliminated on the Michigan return. In addition, a taxpayer must also exclude sales of oil and gas subject to the Severance Tax Act from the calculation of the Michigan apportionment factor.[7]

II. What income must be eliminated?

MCL 206.30(1)(w) requires the elimination of "income from producing oil and gas to the extent included in federal adjusted gross income." Economic interests, such as working interests and royalty interests, will receive a share of income from the production of oil and gas. Income from oil and gas proceeds is required to be eliminated to the extent included in adjusted gross income and is required to be reported on Michigan Form *Schedule 1 Additions and Subtractions*.

i. What is "income from producing oil and gas"?

In understanding the extent and scope of income required to be eliminated, there are two important components to the statutory language. First, the statute requires the elimination of the "income from *producing* oil and gas to the extent included in adjusted gross income." Neither the Income Tax Act nor the Severance Tax Act defines the term "producing." Undefined statutory terms are afforded their plain and ordinary meanings and it is appropriate to consult dictionary definitions in such situations.[8] When looking to a dictionary, the words are to be given meaning based upon the particular context or setting.[9] There are numerous dictionary definitions for the term "produce." As most appropriate to the oil and gas industry, "produce" is defined to mean "to bring [oil, etc.] to the surface of the earth."[10]

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[6] Cf. Treas. Reg. 1.613-5(a).
[7] MCL 206.121.
[8] *Halloran v Bhan,* 470 Mich 572, 578 (2004) (citing *Griffith ex rel Griffith v State Farm Mut Auto Ins Co*, 472 Mich 521, 526 (2005)).
[9] *Tyler v Livonia Pub Sch,* 459 Mich 382, 391 (1999).
[10] PRODUCE, Black's Law Dictionary (10th ed 2014).

Second, the statute requires the elimination of income "from" producing oil and gas. "From" is defined, in relevant part, to mean a term "used as a function word to indicate the source, cause, agent, or basis."[11] In effect, "from" requires causality between the income and production activity of extracting the oil and gas from the earth. Therefore, income "from" producing generally relates to production-phase income and excludes income generated by certain pre- and post-production activities.

Income is subject to elimination where that income results from extracting the oil or gas from the earth. With this general framework in mind, it is helpful to review some examples of common transactions relative to the oil and gas industry:

1. *Working Interest and Royalty Interest Share of Production*

Any income generated by a working interest must first be distributed to royalty interest holders based upon their contractual share of production income. For purposes of determining the amount of income that must be eliminated by working interest holders, the income that is eliminated is computed net of the amounts paid to royalty owners and the other owners of economic interests in the property.[12] Likewise, the share of production income received by a royalty interest holder will be subject to elimination.

2. *Bonus Payments*

In addition to the retention of a royalty interest in productive property, a lease agreement typically provides for an upfront payment of cash to the lessor in consideration for the lease. For federal income tax purposes, a cash bonus payment has been generally regarded as an advance royalty to the lessor. Unless otherwise modified by the operating agreement, the working interest or operator of the property may offset any future share of production income by the advance royalty payment.[13] Bonus payments received may therefore be eliminated by the lessor.[14]

Any payments eliminated as a share of future production income will be subject to the tax benefit rule.[15] The tax benefit rule acts to "cancel out" an earlier deduction where a later event occurs that is fundamentally inconsistent with the premise on which the deduction was initially based.[16] That is, if the occurrence of the event in the same taxable year would have foreclosed the deduction, then the tax benefit rule will require reversal of the deduction where that event occurs in a later year.[17] The subsequent discovery that the property is not capable of production is fundamentally inconsistent with the elimination of a payment as a share of future production. Thus, if property is unproductive and the taxpayer previously eliminated income as a future production payment

[11] http://www.merriam-webster.com/dictionary/from (accessed October 25, 2016).
[12] Cf. *Mesa Petroleum Co v Comm'r*, 58 TC 374 (1972); 26 CFR 1.613–2(c)(5)(i).
[13] *Anderson v Helvering*, 310 US 404, 409 (1940) ("Cash bonus payments, when included in a royalty lease, are regarded as advance royalties, and are given the same tax consequences.").
[14] *Burnet v Harmel*, 287 US 103, 112 (1932).
[15] See *Sturrus v Dep't of Treasury*, 292 Mich App 639, 648-650 (2011).
[16] *Hillsboro Nat Bank v Comm'r*, 460 US 370, 383-384 (1983).
[17] *Id*.

(*e.g.*, advance royalty, bonus payment), then the eliminated income must be added back to Michigan taxable income in the year the property is determined to be unproductive.

3. Delay Rentals

Typically, oil and gas leases require the property to be developed within a specified period of time. If drilling is not commenced within that period, then the lessee may be required to make payments to the lessor in order to retain the production rights while the property remains undeveloped. These payments are called "delay rentals." Delay rental payments are not payments for the production of oil and gas; instead, they are payments for the privilege of retaining the lease without yet bringing the property to production. Because these payments are not "from" producing oil and gas, they are not subject to elimination in Michigan.

4. Income from the Sale or Lease of Property Interests, including Income from Recaptured Costs Under IRC 1254

Generally, the federal income tax treatment of the transfer of an interest in oil and gas property depends on its characterization as a either a lease, sublease, or sale. A lease or sublease is any transfer in which the transferor retains a non-operating, continuing interest in the property. Any transaction where the transferor does not retain a non-operating, continuing interest in the property is a sale. Based on whether the transaction is a sale, lease, or sublease, a taxpayer will report either ordinary income or capital gain on the federal return. In addition, the sale of all or a portion of an economic interest in production property may result in the recapture of certain costs as ordinary income pursuant to IRC 1254.[18]

Notably, the tax levied under the Severance Tax Act is imposed "in lieu of all other taxes, state or local, upon the oil or gas, *the property rights attached thereto or inherent therein, or the values created thereby;* upon all leases or the rights to develop and operate any lands of this state for oil or gas, *the values created thereby and the property rights attached to or inherent therein*."[19] A tax on capital gains or ordinary income that results from the exchange of a mineral right, including income resulting from the IRC 1254 recapture of costs, constitutes a tax on the value of oil and gas property interests. Thus, taxpayers must subtract income resulting from the sale or lease to the extent such income is included in Adjusted Gross Income.

Sale or lease transactions involving mineral rights may also include other real or personal property interests, such as machinery, equipment, and other assets. Only the portion of income resulting from the gain on the real property interest may be excluded pursuant to Section 15 of the Severance Tax Act. Income or gain related to other assets, such as machinery and equipment, may not be eliminated on the Michigan return.

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[18] IRC 1254. Recaptured costs that result in the recognition of ordinary income generally include depletion, intangible development costs, and exploration costs.
[19] MCL 205.315 (emphasis added).

5. *Income from the Sale of Production Equipment*

Owners and lessees may also sell production equipment. Like the sale of an interest in the land, the sale of production equipment generates capital gains and losses on the federal return.[20] Any gain or loss is to be reported on Michigan Form 4797 – *Michigan Adjustments of Gains and Losses From Sales of Business Property*. Because these transactions result from the disposition of equipment and are not from oil and gas production, the income is not subject to elimination on the Michigan return.[21]

6. *Income from Post-Production Activities*

Income may also be generated from certain activities which are performed or occur only after the production of oil and gas. Such income is not subject to elimination in Michigan. As defined, "oil and gas" means "oil and gas subject to tax under [the Severance Tax Act]." The Michigan severance tax is only levied "as of the time when and at the place where the production was severed or taken from the soil immediately after the severance."[22] Post-severance activities or income are not included in the tax base for the Michigan severance tax and are therefore not subject to elimination.[23] As an example, this includes income earned from transportation, delivery, or marketing services.

III. What expenses must be eliminated?

Section 30(1)(w)(ii) requires taxpayers to eliminate all expenses of producing oil and gas to the extent deducted in arriving at adjusted gross income. Expenses that are deducted in arriving at adjusted gross income and subject to elimination are reported as additions to income on Michigan Form *Schedule 1 Additions and Subtractions*. Taxpayers operating wells within and outside Michigan must apportion expenses to Michigan-based wells for purposes of computing and reporting the elimination required by statute.

i. *What are the "expenses of producing oil and gas"?*

In interpreting the language of MCL 206.30(1)(w)(ii), the statute's words are the most reliable indicator of legislative intent and should be interpreted based on their ordinary meaning and the context within which they are used in the statute.[24] Each word of a statute is presumed to be used for a purpose, and, as far as possible, effect must be given to every clause and sentence.[25] Here, the statute requires taxpayers to eliminate the "expenses of producing oil and gas." "Of" is defined to mean "belonging to, relating to, or connected with (someone or something)."[26] As explained

[20] IRC 1231.
[21] Cf. MCL 205.315 ("Nothing herein contained shall in anywise exempt the machinery, appliances, pipe lines, tanks and other equipment used in the development or operation of said leases, or used to transmit or transport the said oil or gas.")
[22] MCL 205.303(1).
[23] Cf. 26 CFR 1.613-3 (defining gross income of oil and gas as "the amount for which the taxpayer sells the oil or gas in the immediate vicinity of the well").
[24] *People v Morey*, 461 Mich 325, 330 (1999).
[25] *Univ of Mich Bd of Regents v Auditor General*, 167 Mich 444, 450 (1911).
[26] http://www.merriam-webster.com/dictionary/of (accessed October 24, 2016).

more fully below, expenses that are "connected with" producing oil and gas include not only the direct operating expenses, but also all other indirect expenses necessary to bring about production.

a. Direct Expenses of Producing Oil and Gas

Working interest holders are burdened with the costs and expenses of bringing the well to production and will incur the direct operating expenses related to production. Working interest holders that are engaged in a trade or business are entitled to deduct operational expenses in the calculation of federal adjusted gross income. These expenses include "the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business."[27] Common examples of ordinary and necessary expenses incurred by producers and working interest holders include salaries and wages, insurance, overhead, severance taxes paid, administrative and financial overhead, and depreciation. These direct expenses are "expenses of producing oil and gas" under MCL 206.30(1)(w).

In contrast, royalty and overriding royalty interest holders receive a share of production income free of the expenses of production. With the most notable exception of depletion, a royalty interest holder will therefore not be likely to report any regular operating expenses requiring elimination on the Michigan return.

b. Indirect Expenses of Producing Oil and Gas

Indirect and other intangible costs that are necessary for the successful extraction of oil and gas are also expenses "connected with" producing oil and gas. This is supported by operations and accounting methods used within the oil and gas industry. Generally, the oil and gas industry operates in three general phases:

1. Acquisition;
2. Exploration and Development, and;
3. Operation.

Each phase within this process requires large amounts of expenses and capital investment to achieve the production of any oil and gas. For example, there are significant fees and transactional costs related to the acquisition of an interest in the property. Subsequent exploration costs to determine the existence, location, extent, and quality of any resources are necessary to determine whether the property is capable of production. And regular operating expenses can begin only once production has been achieved and stabilized. The actual production of oil and gas income is therefore the culmination of various expenditures on the property, both direct and indirect.

That all such expenses are "connected to" production of oil and gas is supported by accounting methods within the industry. It is generally necessary that indirect or other pre-production expenses related to acquisition, exploration, and development of the property be capitalized and expensed over the productive life of the property.[28] This allows for pre-production and other

[27] IRC 162.
[28] FAS 19; 17 CFR 210.4-10(c)(2).

capitalized costs to be expensed alongside the share of production income that those expenses helped generate. That is, basic accounting principles recognize that these expenses are "connected with" the income being generated by those expenses.

In some instances, elections under the federal code allow for the immediate expensing of costs rather than capitalizing and expensing the costs over the life of the productive property. Because eliminations are required to the extent expenses are deducted in arriving at adjusted gross income, any federal election to immediately deduct expenses will require a corresponding elimination of expenses on the Michigan return.

i. Depletion

Depletion is an accounting and tax concept that allows for the recovery of costs measured by the reduction of the natural resource reserves on the property. Depletion is designed to balance the finite characteristics of natural resources with the recovery of capital for successfully developing mineral property.[29] The deduction is claimed only after the retail sale of oil and gas and may be claimed based upon the greater of either the percentage method or the cost method of depletion. Depletion is available to be claimed by any holder of an economic interest in production, and is likely to be reported on the returns of recipients of income from mineral interests, royalty interests, overriding royalty interests, net profits interests, and production payments.

For partnerships, the depletion deduction is not claimed at the partnership level. Rather, the depletion deduction must be computed at the individual partner's level and is subject to the limitations of Sections 611 – 613A of the Internal Revenue Code. Each partner must keep track of the adjusted basis in partnership oil and gas properties to properly compute the depletion deduction.

ii. Intangible Drilling Costs

Intangible Drilling Costs (IDC) generally refers to the expenditures that are incident to and necessary for the drilling and preparation of wells for the production of oil and gas. This generally includes all expenditures for non-salvageable items or expenses such as wages, fuel, repairs, hauling, and supplies. Typically, these costs are capitalized and recovered through annual depreciation and depletion expense accounts.[30] However, the federal rules also provide working interest holders an election to immediately expense these costs.[31] A taxpayer who elects to expense IDC must do so on the return for the first taxable year in which the taxpayer incurs such costs. The election, which is irrevocable, is only available to holders of working interests. Because these expenses represent necessary expenditures for the production of oil and gas, a taxpayer is required to eliminate IDCs on the Michigan return consistent with the federal election to either capitalize or expense those costs.

Federal regulations create an additional election for taxpayers who elect to capitalize IDC but subsequently discover that a well is not capable of production. In that case, the taxpayer may make

[29] IRC 613.
[30] 26 CFR 1.612-5(b)(1)-(3).
[31] IRC 263(c).

a second election to expense the capitalized IDC in the first tax year after the nonproductive well is completed.[32] Because this election is only available where the well is proven to be not capable of production, the IDC expensed pursuant to this election is not subject to elimination on the Michigan return. Likewise, a taxpayer who forgoes the election and continues to recover those costs through capital accounts is not required to continue to eliminate those costs on the Michigan return. Regardless of the election to capitalize or expense these costs, if the well is later discovered to be not capable of production, then taxpayers who eliminated IDCs on a prior Michigan return may either file an amended return for that prior year or deduct an amount equal to the IDC previously eliminated in the year the well was determined to be nonproductive.

For partnerships, intangible drilling costs and any subsequent election are determined at the partnership level and allocated to each partner based on his or her share of ownership in the partnership. The partner is required to follow the partnership's elections with respect to the elimination of IDCs on the individual tax return.

IV. How are income and expenses from producing oil and gas treated in calculating the Michigan Net Operating Loss?

The individual income tax treatment of Federal and Michigan Net Operating Losses (NOLs) is set forth within Section 30 of the Michigan Income Tax Act. That section provides that taxable income is computed based on federal adjusted gross income, subject to additional adjustments which include:

> (m) Add, to the extent deducted in determining adjusted gross income, the net operating loss deduction under section 172 of the internal revenue code.
>
> (n) Deduct a net operating loss deduction for the taxable year as determined under section 172 of the internal revenue code subject to the modifications under section 172(b)(2) of the internal revenue code and subject to the allocation and apportionment provisions of chapter 3 of this part for the taxable year in which the loss was incurred.

Application of the NOL provisions to oil and gas income and expenses was originally examined in *Cook v Department of Treasury.*[33] The issue in that case was whether expenses allocated to the production of oil and gas income should be excluded from the Michigan NOL. The Court held that IRC 265(a)(1), which disallows deductions related to exempt income, applies in Michigan and prevents any deduction of expenses allocable to the production of exempt income. Because oil and gas income was exempt from tax in Michigan, the expenses associated with such activity were therefore excluded from the computation of the Michigan NOL.

The precise issue examined in *Cook* was later revisited in *Elenbaas*. Notably, the conflict in *Elenbaas* was twofold and included whether oil and gas expenses were included both in the computation of Michigan taxable income *and* in the computation of the Michigan Net Operating Loss. The Court of Appeals allowed the expenses to be claimed only with respect to Michigan

[32] 26 CFR 1.612-4(b)(4).
[33] *Cook v Dep't of Treasury,* 229 Mich App 653 (1998).

taxable income. In addressing the computation of the NOL, the Court ultimately acknowledged that "the *Cook* panel reached the correct result" and concluded that it was error "to deduct the expenses associated with oil and gas production in computing a net operating loss."[34] Thus, *Elenbaas* acknowledged that both exempt income and expenses were excluded from the computation of the Michigan NOL.

The holding of *Cook* remains valid notwithstanding the enactment of MCL 206.30(1)(w). The codification of the severance tax exemption effectively reversed *Elenbaas* only as to its conclusion that oil and gas expenses could be included in the computation of Michigan taxable income. MCL 206.30(1)(w) does not adjust the computation of the Michigan NOL as authorized under MCL 206.30(1)(n). The portion of the *Elenbaas* opinion that affirms *Cook* and excludes expenses related to exempt income from the NOL computation remains valid law in Michigan. Thus, income and expenses that are not subject to tax in Michigan must be excluded entirely from the computation of the Michigan NOL.

All income and expenses related to producing oil and gas that are eliminated pursuant to MCL 206.30(1)(w) may not be included in the calculation of the Michigan NOL.

V. How is Total Household Resources calculated using oil and gas income and expenses?

"Total Household Resources" is used for Michigan Individual Income Tax purposes to compute the homestead property tax credit and the home heating credit. Total Household Resources is defined to mean:

> [A]ll income received by all persons of a household in a tax year while members of a household, increased by the following deductions from federal gross income:
>
> (a) Any net business loss after netting all business income and loss
>
> (b) Any net rental or royalty loss
>
> (c) Any carryback or carryforward of a net operating loss as defined in section 172(b)(2) of the internal revenue code[35]

For purposes of Total Household Resources, income is defined, in relevant part, as "the sum of federal adjusted gross income as defined in the internal revenue code plus all income specifically excluded or exempt from the computations of the federal adjusted gross income."[36] This language is unaffected by the requirement that income and expenses from oil and gas be eliminated from Michigan taxable income. Elimination is not permitted by statute for oil and gas income or expenses in the computation of Total Household Resources. Taxpayers must therefore include the net income from oil and gas production in calculating Total Household Resources.

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[34] *Elenbaas v Dep't of Treasury*, 235 Mich App 375 (1999).
[35] MCL 206.508(4).
[36] MCL 206.510(1).

VI. What records must be maintained and reported when eliminating oil and gas income and expenses on an income tax return?

Taxpayers are required to keep accurate and complete records necessary for the proper determination of a tax liability.[37] Taxpayers eliminating income and expenses on the Michigan Individual Income Tax Return should attach all federal schedules which substantiate amounts eliminated on the Michigan return. The Department may also request to review additional information substantiating the tax reported on the return, including all federal tax return information or operating agreements related to the items subject to elimination.

VII. Example

The example below illustrates how items reportable on the federal return are eliminated on the Michigan return. For purposes of this example, assume that the taxpayer is a Michigan resident and that the amounts reported on Schedule C, Schedule E, and Form 4797 relate to oil and gas operations from Michigan oil and gas wells.

Federal Return Information		
Form W-2 - Wage and Tax Statement		
Wages (Non-oil and gas)		100,000
Schedule C - Profit or Loss From Business		
Gross Income		
Production Income	50,000	
Delay Rental Payments	5,000	
Expenses		
Operating Expenses	(35,000)	
Depletion	(10,000)	
Other Expenses (IDC)	(7,500)	
		2,500
Schedule E - Supplemental Income and Loss		
Royalty Income	10,000	
		10,000
Form 4797 - Sales of Business Property		
Gain on Sale of Prod. Equipment	40,000	
Gain on Sale of Mineral Interest	25,000	65,000
Federal Adjusted Gross Income		**177,500**

Michigan Income Subject to Tax		
Federal Adjusted Gross Income		**177,500**
Michigan Schedule 1 Additions and Subtractions		
Additions to Income		
Operating Expenses	35,000	
Depletion	10,000	
Other Expenses (IDC)	7,500	
		52,500
Subtractions from Income		
Production Income	(50,000)	
Royalty Income	(10,000)	
Gain on Sale of Mineral Interest	(25,000)	
		(85,000)
Michigan Income Subject to Tax		**145,000**

Income from federal return not subject to elimination:
1. Gain on Sale of Production Equipment (See Section II.i.4)
2. Delay Rental Payments (See Section II.i.3)

[37] MCL 206.455.