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MICHIGAN
DEPARTMENT OF
TREASURY

REVENUE ADMINISTRATIVE BULLETIN 2001-5
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Individual Income Tax - Severance Tax Paid in Lieu of Other Taxes

RAB 2001-5. This Revenue Administrative Bulletin (RAB) describes the exemption from income tax afforded producers of oil and gas in Michigan by the Severance Tax Act. This bulletin replaces RAB 1996-1 and rescinds RAB 1989-22 to the extent it refers to income tax.

ISSUES

I. What is severance tax?

II. How does the severance tax relate to federal adjusted gross income (AGI) for purposes of computing Michigan income tax?

III. Are Michigan oil and gas receipts that are subject to severance tax also subject to income tax?

IV. Who is eligible to deduct oil and gas income on the income tax return?

V. What income may be deducted on the income tax return?

VI. How is the amount of gross receipts subject to severance tax computed?

VII. How does the severance tax exemption affect the computation of a Michigan net operating loss?

VIII. Does the severance tax exemption affect household income for computing a property tax credit?

IX. Does the severance tax exemption affect a gain or loss included in AGI from the sale of assets used in the extraction of oil and gas in Michigan?

X. What records must be maintained and reported when deducting oil and gas income on an income tax return?

XI. What is the effective date of this RAB?

CONCLUSIONS

I. The Michigan Severance Tax Act levies a specific tax upon each producer engaged in the business of severing oil or gas from the soil in this state. The tax rate is 5% of the gross cash market value of the total production of gas, 6.6% of the gross cash market value of the total production of oil, or 4% of the gross cash market value of oil from marginal or stripper wells, exclusive of production derived from land or rights owned by governmental entities. The severance tax base is the market value of the product at the wellhead immediately after it is severed from the ground [MCL 205.301; MCL 205.303].

II. The Income Tax Act (ITA) levies a tax upon the taxable income of any person subject to tax for receiving, earning, or otherwise acquiring income from any source whatsoever. For Michigan income tax purposes, taxable income means federal adjusted gross income (AGI) subject to certain adjustments. Since AGI includes gross income from all sources, presumably, any receipts from the production of oil and gas in this state are included in federal AGI.

III. The Severance Tax Act provides that the severance tax is in lieu of all other taxes, state and local, upon the oil or gas, the property rights attached thereto or inherent therein, or the values created thereby [MCL 205.315]. Therefore, the income from oil and gas subject to severance tax is not subject to individual income tax.

IV. As defined in the Severance Tax Act, a producer is a person who owns, or is entitled to delivery of a share in kind or a share of the monetary proceeds from the sale of, oil or gas as of the time of its production or severance [MCL 205.312(2)]. Only a producer that meets the Severance Tax Act definition may deduct gross receipts that are also subject to severance tax when computing Michigan taxable income for individual income tax purposes.

V. When computing Michigan taxable income, a producer may claim a deduction for oil and gas receipts that were subject to the severance tax but only to the extent the receipts were included in AGI. The value of the severed product at the wellhead is the only amount eligible for a deduction on the income tax return. Expenses applicable to those oil and gas receipts, which are deducted on the federal return, remain deductible except in computing a Michigan net operating loss (See VII below.)

VI. The Severance Tax Act provides that the tax value of all production of oil and gas shall be computed at the wellhead. If the market is away from the wellhead, there may be marketing costs allowed as deductions from the selling price determined at such time as title to the severed product transfers to the purchaser of the oil or gas. The deductions are used to arrive at the wellhead value.

The income tax deduction for gas receipts subject to severance tax is only allowed on the gross receipts equal to the market value at the wellhead, not after processing. If the gross receipts shown on a 1099, K-1, or other federal income tax or reporting form reflect the market value at the processing plant, not the wellhead, the taxpayer must adjust the deduction on the income tax return to equal the wellhead value. The taxpayer must obtain this information from the common producer or whomever issues the federal tax reporting document.

VII. Taxpayers may not compute a Michigan net operating loss (NOL) using oil and gas income and expenses to carryback or carryforward to another tax year. No Michigan NOL may be computed for oil and gas activity or increased by the expenses related to income deducted on the income tax return.

The ITA requires that any federal NOL deduction be added back to AGI when computing Michigan taxable income. If a taxpayer has a federal NOL from Michigan oil and gas activity, that NOL deduction must be added back to AGI, like any other federal NOL deduction. However, since a taxpayer may not compute a Michigan NOL and NOL deduction based on Michigan oil or gas activity, the Michigan NOL deduction would be zero.

A business entity with income from both an activity subject to severance tax and another business activity not subject to severance tax must allocate expenses between the severance taxed income and the other revenue source if computing a Michigan NOL on the business activity that is not subject to severance tax. The taxpayer must allocate each expense to the appropriate revenue source or assign a percentage of each expense to the appropriate revenue source. The basis for the percentage must accurately reflect the expense associated with the revenue source. Exploration, development, production, allocated overhead, and expenses from nonproductive wells, such as dry hole costs, shall be allocated to the oil and gas income.

VIII. For purposes of computing the homestead property tax, home heating, farmland preservation, and prescription drug credits, household income must still include the income/loss from the oil and gas activity. When computing household income, "income" is " . . . the sum of federal adjusted gross income as defined in the Internal Revenue Code (IRC) plus all income specifically excluded or exempt from the computations of the federal adjusted gross income . . ." [MCL 206.510(1)]. Therefore, no adjustments are permitted for oil and gas income when computing household income.

IX. The basis of assets used in the production of oil and gas for Michigan income tax purposes is the same as the basis reported on the federal income tax return. Therefore, a gain recognized from the recapture of depreciation, amortization and intangible drilling costs on the federal return is taxable on the Michigan return as the gain on the sale of an asset. No adjustment is permitted on the income tax return for gains on the sale of production assets.

X. The ITA requires that taxpayers keep and maintain accurate records in a form sufficient to determine the tax due [MCL 206.455]. To report a deduction for oil and gas royalty interest and working interest, the taxpayer must attach a copy of the federal schedules, such as Schedules C and E, to the MI-1040. Any supporting documentation must be obtained by the taxpayer from the common purchaser or other severance taxpayer.

XI. This RAB applies to all open tax periods. In general, a taxpayer may file a claim for a refund of overpaid taxes within four years of the due date of the return, including extensions [MCL 205.27a]. A taxpayer may file an amended Michigan income tax return for any tax period within the four-year statute of limitations to claim a refund of any overpaid taxes based on the exemption afforded oil and gas income by the courts.

LAW AND ANALYSIS

In *Bauer v Dep't of Treasury*, 203 Mich App 97; 512 NW2d 42 (1993), lv den 447 Mich 979 (1994), the Court of Appeals held that the Severance Tax Act, MCL 205.315, exempted oil and gas royalty income from individual income taxes. The Court relied on section 15 of the Severance Tax Act which reads: "[t]he severance tax herein provided for shall be in lieu of all other taxes, state or local, upon . . . the values created . . ." and concluded "that the payments on a royalty interest are not subject to personal income tax." *Bauer, id* at 203 Mich App 101. Taxpayers may deduct income that was also subject to severance tax on the Michigan income tax return. *Bauer* did not address the treatment of expenses incurred in producing the exempt income. The Department's interpretation of *Bauer* was set forth in RAB 1996-1.

In the combined decisions *Cook v Dep't of Treasury* and *Miller v Dep't of Treasury*, 229 Mich App 653; 583 NW2d 696 (1998), the Court of Appeals held that taxpayers must exclude exempt oil and gas income and related expenses in calculating a Michigan NOL deduction under Section 30(1)(p) of the ITA. The Court of Appeals in *Cook* and *Miller* found that, because the ITA relies on the IRC when computing Michigan taxable income, a taxpayer may not compute a Michigan NOL using expenses related to exempt income. IRC § 265 prohibits deductions for expenses related to tax exempt income. The Court determined that a taxpayer may not compute a Michigan NOL based on Michigan oil and gas expenses because the related income is exempt per the Severance Tax Act.

In *Elenbaas v Dep't of Treasury*, 235 Mich App 372; 597 NW2d 271 (1999), the Court of Appeals affirmed its decision in *Cook* and *Miller* and held that taxpayers could calculate their Michigan taxable income by excluding their gross income from oil and gas activities subject to severance taxes while still deducting related expenses, except in years in which taxpayers have a loss from oil and gas activities taxpayers must exclude both income and related expenses from the calculation of a NOL. The Department, taking *Elenbaas*, *Cook*, and *Miller* into consideration, has determined that taxpayers cannot compute a Michigan NOL using oil and gas expenses to carryback or carryforward to another tax year.

The Michigan Supreme Court denied leave to appeal on all issues in the above cases on December 7, 2000. The effect of this denial leaves the final published Michigan Court of Appeals decisions as binding.

<u>Definitions</u>

The following definitions are used in this RAB.

"AGI" means adjusted gross income as defined in IRC § 62.

“Gas” does not include methane gas extracted from a landfill [MCL 205.311].

"Gross income" means gross income as defined in IRC § 61.

"IRC" means the United States Internal Revenue Code of 1986 in effect on January 1, 1996, or at the option of the taxpayer, in effect for the tax year.

“ITA” means the Income Tax Act, 1967 Public Act 281, MCL 206.1 et seq.

“Oil” as used in the Severance Tax Act means petroleum oil, mineral oil, or other oil taken from the earth [MCL 205.311].

“Producer” means a person who owns, or is entitled to delivery of a share in kind or a share of the monetary proceeds from the sale of, oil or gas as of the time of its production or severance [MCL 205.312(2)].

“Severance Tax Act” refers to Public Act 48 of 1929, MCL 205.30 et seq.

"Taxable income" means adjusted gross income as defined in the Internal Revenue Code subject to certain adjustments prescribed in the ITA at MCL 206.30.