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The Depletion Deduction: A Unique Tax Deduction for the Oil & Gas Industry

Depletion is defined as, "The using up of natural resources by mining, drilling, quarrying stone, or cutting timber. The depletion deduction allows an owner or operator to account for the reduction of a product's reserves." Generally, the costs to acquire an oil and gas property are referred to as capitalized leasehold costs. Once the property begins producing, the leasehold costs are deducted through either cost depletion or percentage depletion.

Percentage Depletion

Percentage depletion is calculated as a percentage of gross revenue from oil and gas properties. This percentage is currently set at 15%. Since this deduction isn't based off of the amount of a property's leasehold costs, taxpayers can enjoy the benefit of percentage depletion even after all leasehold costs have been recovered – a "freebie" deduction! As with anything that sounds too good to be true, percentage depletion does have limitations:

1. Percentage depletion is the lesser of net income or 15% of gross revenue per property.
2. A taxpayer's total percentage depletion for the year cannot exceed 65 percent of taxable income, computed without deducting percentage depletion, the domestic production activities deduction, and NOL and capital loss carrybacks.
3. Percentage depletion is limited if the average daily production exceeds 1,000 barrels.
4. Percentage depletion is not allowed for foreign producers or domestic retailers/refiners.

Cost Depletion

Cost depletion is calculated on the amount of a property's capitalized leasehold costs and is deducted as the oil or gas is extracted from the property. Cost depletion is beneficial when a property does not qualify for percentage depletion, as there are no net income limitations when determining the cost depletion deduction. The deduction is calculated as follows:

$$\frac{\text{Current Production}}{\text{Current Production} + \text{Ending Reserves}} \times \text{Adjusted Tax Basis of Each Property}$$

Which Method is Most Beneficial? It Depends!

Depletion must be calculated and maintained on a property-by-property basis. Calculating the cost depletion deduction requires each eligible property to have both cost basis and current year production. In determining the percentage depletion deduction, each eligible property must have both current year production and net income. For properties that qualify for both percentage and cost depletion, the depletion deduction will be the greater of the two for each property.

If you have any questions or would like to discuss how the depletion deduction may benefit you, please reach out to Megan Williams – MeganW@gmpcpa.com.