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REVENUE ADMINISTRATIVE BULLETIN 1996-1

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Individual Income Tax - Severance Tax Paid in Lieu of Other Taxes

RAB 96-1. This bulletin explains how *Bauer v Department of Treasury,* 203 Mich App 97; 512 NW2d 42 (1993), affects Michigan Individual and Fiduciary Income Tax returns. *Bauer* held that as provided by MCL 205.315; MSA 7.365, severance tax is paid in lieu of other taxes.

Background

The Severance Tax Act, levies a tax "upon each producer engaged in the business of severing from the soil, oil or gas . . . ." MCL 205.301; MSA 7.351.

In *Bauer*, the Court of Appeals ruled that the relevant portion of the Severance tax act reads: "[t]he severance tax herein provided for shall be in lieu of all other taxes, state or local, upon . . . the values created . . . ." The Court reasoned "that the payments on a royalty interest are not subject to personal income tax." *Bauer, supra,* 203 Mich App 101.

Income Tax Treatment

Based upon *Bauer*, a producer as defined in the Severance Tax Act shall exclude royalty and working interest income to determine Michigan taxable income.

For an individual, Michigan taxable income is defined at MCL 206.30(1); MSA 7.557(130), which states:

> " [t]axable income' means, for a person other than a corporation, estate, or trust, adjusted gross income as defined in the internal revenue code . . . ."

MCL 206.36 (1); MSA 7.557(136) (1) states in part:

> " 'Taxable income' in the case of a resident estate or trust means federal taxable income as defined in the internal revenue code . . . ."

The term "income" includes both positive and negative results from business activity. Federal adjusted gross income (AGI) includes either the net positive or negative income from the oil and gas producing activity.

Adjustment for Gas or Oil Royalties or Working Interests in Determining Michigan Taxable Income

To exclude gas and oil royalty interest and working interest from the Michigan individual income tax base, the taxpayer shall:

1. Deduct the amount of gas and oil royalty interest or working interest income to the extent the income is included in AGI.

2. Add the amount of gas and oil royalty interest or working interest losses to the extent the loss is included in AGI.

To report a deduction or addition for gas and oil royalty interest and working interest, the taxpayer must attach a copy of the federal schedule C and/or E to the MI-1040.

Calculating the Deduction When Revenue Sources Other Than From Royalty and Working Interests are Included in Gross Revenue

A business entity having income from both gas or oil activity and another business activity must allocate expenses between the gas or oil royalty and working interest income and the other revenue source.

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 sources. Exploration, development, production, allocated overhead, and expenses from nonproductive wells, such as dry hole costs, shall be allocated to the gas and oil income.

Net Operating Losses

Because *Bauer* exempts oil and gas royalty or working interest income from income tax, producers shall calculate the Michigan NOL and the NOL deduction without regard to income or losses from Michigan oil and gas production. Net income and losses attributed to oil and gas production included in the federal NOL must be eliminated in the Michigan NOL computation.

Gains From the Disposal of Assets Used in the Production of Oil and Gas

The basis of assets used in the production of oil and gas is the same for Michigan income tax purposes as 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. A loss reported on the federal return cannot be increased by the recapture of depreciation, amortization and intangible drilling costs.

Household Income

For purposes of computing the homestead property tax, home heating, farmland preservation, and prescription drug credits, household income will still include the income/loss from the gas and oil activity. Income for computing household income is defined 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 . . . ." MCL 206.510(1); MSA 7.557(1510(1).

Statute of Limitations

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; MSA 7.657(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. A taxpayer reporting a net loss from oil and gas production must file an amended return to add the net loss and pay the additional tax and interest due.

Intangibles Tax

The Intangibles Tax is levied on the privilege of ownership of intangible property not on the oil and gas production or severance activity described in the Severance Tax Act. Therefore, dividends, interest, distributions, etc., from gas and oil activity are subject to the Intangibles Tax as in the past.