Legislative Analysis

Mitchell Bean, Director
Phone: (517) 373-8080
http://www.house.mi.gov/hfa

OIL AND GAS EXPENSE DEDUCTIONS

House Bills 4387 and 4388 as introduced
Sponsor: Rep. Fred Miller
Committee: Tax Policy

Complete to 4-23-07

A SUMMARY OF HOUSE BILLS 4387 AND 4388 AS PASSED BY THE HOUSE 4-17-07

House Bills 4387 and 4388 would essentially require expenses deducted on a federal income tax return for income subject to the federal income tax, but not the Michigan income tax, to be added back onto the Michigan income tax form for tax years that begin after December 31, 2007. The bills are part of the governor's Fiscal Year 2008 Executive Budget Recommendation.

House Bill 4387 would amend the Income Tax Act (MCL 206.36) to add to federal taxable income for resident estates and trusts, expenses incurred in the production of income that is not taxable under the act, although only to the extent that those expenses were deducted in determining federal taxable income.

House Bill 4388 would amend the Income Tax Act (MCL 206.30) to add to federal adjusted gross income for persons other than corporations, estates, or trusts, expenses incurred in the production of income that is not taxable under the act, although only to the extent that those expenses were deducted in determining federal AGI.

Under the state Income Tax Act, the starting point for determining the tax liability for estates and trusts is federal taxable income, and the starting point for determining an individual's income tax liability is federal adjusted gross income (AGI), both of which are then subject to various adjustments to determine state taxable income (See, generally, Michigan and IRS tax forms 1040 and 1041.) For federal taxation purposes, income levels include business income or losses, which include royalty income and related expenses from oil and gas wells. The state, however, imposes the severance tax on the gross proceeds of oil and gas "severed" from the earth in lieu of all other state and local taxes, including the income tax. [See Bauer v. Department of Treasury – 203 Mich App 97 (1993)]

FISCAL IMPACT:

The bills would increase General Fund/General Purpose (GF/GP) revenue by an estimated $2.9 million and School Aid Fund (SAF) revenue by an estimated $1.0 million in Fiscal Year 2008.

BACKGROUND INFORMATION:

According to the Department of Treasury's Revenue Administrative Bulletin 2001-5, for individual returns, a producer may claim a deduction for oil and gas receipts (gross income) that were subject to the severance tax, *but only to the extent that the receipts were included in calculating AGI*. With relevance to these bills, there is no statutory requirement that the expenses related to oil and gas income deducted on a federal return be added back onto a Michigan income tax return when determining state taxable income. [Taxpayers are not necessarily deducting these expenses again on the Michigan income tax return, but these expenses are used to determine Michigan taxable income to the extent that they are already included in federal taxable income or adjusted gross income.]

The Department of Treasury has contended in the past that since the oil and gas royalty income is not used to determine Michigan taxable income, the related expenses should also not be used to determine Michigan taxable income. By not adding back oil and gas expenses, they are, in theory, used to offset other types of income, such as wages, on the Michigan tax return. The bills are similar in concept to a provision in the federal Internal Revenue Code, 26 USC 265(a)(1a), that prohibits a deduction for expenses related to income that is exempt from taxation under the IRC.

In the past few years, state courts have issued several rulings on how oil and gas expenses and income are treated under the Severance Tax Act and the Income Tax Act. In Elenbaas v. Department of Treasury [231 Mich App 801 (1998) and 235 Mich App 372 (1999)], the court ruled that gross receipts, rather than net income, from the production of oil and gas may be deducted from adjusted gross income in determining state tax liability. The court noted that the severance tax is paid on the gross receipts from oil and gas production, without allowing a deduction for related expenses, and stated, "[i]f gross receipts are taxed under the severance tax act, then it necessarily follows that gross receipts, not net income, are exempt from taxation under the [Income Tax Act]."

In allowing a deduction from the Income Tax Act for oil and gas production expenses, the court stated, "[w]e also disagree with the [treasury department's] argument that allowing deductions for the expenses associated with oil and gas production amounts to allowing plaintiffs to take deductions without paying taxes on the income derived from the oil and gas ventures, which gave rise to the deductions. The Michigan severance tax is imposed on gross receipts, which include income derived from the production of oil and gas without any deductions being taken. Thus, we find it disingenuous for [the department] to argue that no tax is being paid on the income derived from the oil and gas ventures. More importantly, the fact that the gross receipts are taxed under the severance tax without an allowance for expenses under that act reinforces that the corresponding deduction for expenses should be taken under the [Income Tax Act]." [See the 1998 decision, Elenbaas 1.]

The court's decision in Elenbaas 1 conflicted with a prior ruling in Cook v. Department of Treasury 229 Mich App 653 (1998) and, pursuant to court rules, the Elenbaas 1 panel was constrained to follow the Cook decision. A special panel was convened to resolve the conflict between the Elenbaas I and Cook decisions. The Elenbaas 2 panel for the most part agreed with and adopted the reasoning of Elenbaas I and allowed deductions from the income tax for gross receipts from oil and gas production, as well as those related expenses. However, it did not allow a net operating loss deduction resulting from those expenses.

Legislative Analyst: Mark Wolf
Fiscal Analyst: Rebecca Ross
Jim Stansell