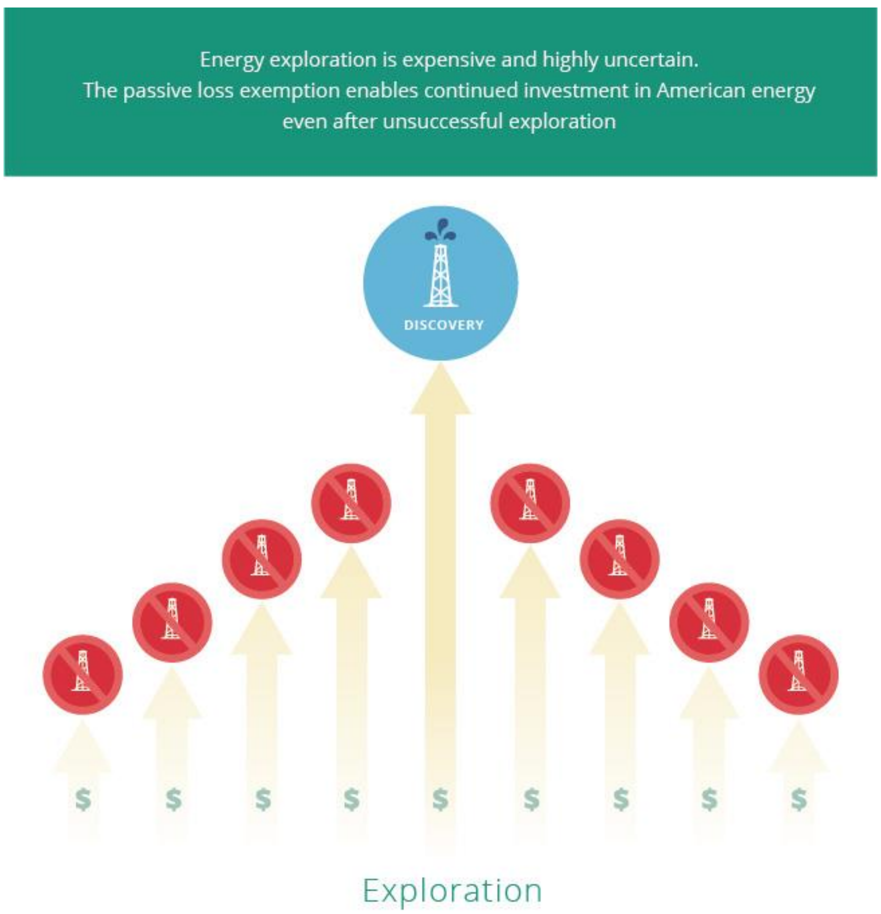
Passive Loss Exception

Why is the Passive Loss Exception an Issue?

The passive loss exception enables working interest owners in oil and natural gas production to achieve some parity between their investments and those of corporate shareholders. By counting any working interest investment losses as active instead of passive, investors are able to treat the normal business deductions from their investment in the same way that a corporation would. But the Obama Administration would repeal the passive loss exception.



Why was the Passive Loss Exception Created?

The passive loss exception reflects Congressional recognition that the Tax Reform Act of 1986 created an inequity. The Tax Reform Act divided investment income/loss into two baskets – active and passive. Moreover, the passive loss rules apply only to individuals; corporations pass the same deductions to shareholders as part of the overall value of the stock. If income/loss, arising from natural gas and oil working interests, were treated as passive income/loss, taxpayers would be significantly less willing to risk an investment in natural gas and oil development.

Most American wells today are drilled by small and independent companies, many of which depend on individual investors. There is no sound reason for Congress to enact tax rules that would discourage individual investors from continuing to participate in energy investments. The repeal of the working interest rule, therefore, would senselessly drive natural gas and oil investments away from individuals and toward corporations.

What is Active Versus Passive?

Passive income and loss are based on an activity in which the investor is not "materially" involved. According to the IRS, material involvement is on a "regular, continuous, and substantial" basis. For example, if an investor buys shares in a rental property – in which he or she is not actively involved in operating or maintaining – the investment is considered passive. This is the same for limited partnerships – a limited partner invests in the partnership but is not involved in the day to day activity and operations.

Limited partners are vital to the investment in oil and natural gas, spurring investment in American energy. Unfortunately, drilling a well does not guarantee resource production; yet the capital costs of exploration – successful or not – are extremely high. Because of the passive loss exception, working interests in oil and natural gas are removed from the passive income basket. In other words, all oil and gas working interests are considered active, even if the investor is not the operator of the drilling and production operations.

Importantly, investors in working interests are engaged in the very real activity of exploring for and developing oil and natural gas resources. Moreover, these investors are allowed deductions only for the actual expenses incurred and paid by them with respect their working interests. Working interest owners cannot deduct any expenses that have not actually been incurred by them and for which they are not entirely liable. By defining this income/loss as active, these investors and partners are able to continue advancing American energy exploration and production.

Why is Passive Loss Exception Important to American Energy?

The passive loss exception enables continued investment into American energy exploration, supporting the small businesses and the countless other industries and consumers who benefit from affordable, secure American energy. By allowing individual investors to participate actively in oil and natural gas production ventures, investment is able to continue where it would otherwise be lost.