Tax Shelter Depends on Each Investor's Situation

Summary

The income tax treatment of trusts and partnerships may be advantageous even to tax-exempt investors because there is no taxation at the trust or partnership level. Moreover, unitholders pay income tax only on the amount of income generated after an allowance for depletion, i.e. return of principal. In addition, natural gas produced from coal seams or tight sands earns tax credits that can reduce taxation from other sources. As a result the taxable equivalent of a dynamic distribution yield on Cross Timbers Royalty Trust of 12%, for example, may be as high as 21%. Because that might just as readily overstate the case, we describe alternate outcomes in the context of explaining the taxable equivalent calculation.

Depletion Valued Most by Long-Term Holders

Unlike a bond where the holder ultimately recovers his principal in the usual case, a natural gas property just keeps producing until the wells run dry. The tax interpretation is that the original investment is recovered in proportion to production. That is, if 9% of the reserves of a property are produced in a year, 9% of the cost basis can be claimed as depletion. Since estimates of natural gas reserves are often understated, depletion is often overstated. Earlier recovery of investment through rapid depletion has the effect of deferring taxation.

The federal government recaptures taxes on depletion from unitholders who receive more than their tax cost basis on the sale of the units. A unitholder who buys and sells for a gain in 13 months would find his distribution taxed at the full rate for ordinary income and his gain taxed at the reduced rate for a long-term capital gain.

Credit Valued Most by Holders with Highly-Taxed Income

Non-conventional source fuel tax credits reduce only those taxes paid at rates above the alternative minimum rate, currently 28%. Credits not used can be carried forward. As a result a taxpayer that does not use all his credits would find his tax rate essentially capped at 28%.

Taxable Equivalence Assumes High Rate and Full Use of Credits

To start the calculation of taxable equivalence, we calculate depletion of a cost basis equal to current market value, as would be the case if the units were just purchased. Distribution, or cash flow in the case of a partnership, minus depletion equals taxable income. We calculate tax assuming a 39.6% tax rate, the highest federal bracket before special considerations. Adding distribution and tax credit and subtracting tax gives us after-tax income. Dividing that amount by 60.4% gives us the income that would have to be earned to be equivalent if fully taxed.