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Pennsylvania Inheritance Tax
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Oil & Gas Lease

ISSUE

Is a leasehold interest for oil and gas held by a Taxpayer at death subject to Pennsylvania Inheritance Tax where gas wells had been drilled prior to Taxpayer's death but no gas found or removed?

CONCLUSION

Leasehold interests for oil and gas held by a decedent at death are subject to Pennsylvania Inheritance Tax. However, where no oil or gas existed on the property at the Taxpayer's date of death, the interests have no ascertainable value for inheritance tax purposes.

FACTS

Taxpayer inherited various oil and gas leases in 1967. Prior to his death, two shallow (less than 6,000 feet deep) oil and gas wells were drilled. Shallow gas production began on March 12, 1981. Taxpayer died on July 23, 1981. In 1998, deep wells were drilled by a third party developer, locating gas and oil. At issue is whether Taxpayer's leasehold interests were subject to tax at his death.

DISCUSSION

The Inheritance and Estate Tax Act of 1991 defines "value," as:

The price at which the property would be sold by a willing seller, not compelled to sell, to a willing buyer, not compelled to buy, both of whom have reasonable knowledge of the relevant facts.

72 P.S. § 9102[26].

Similarly, the Internal Revenue Service values oil and gas leasehold interests based on the interest's fair market value at the date of death, which is:

the price at which the property would change hands between a willing buyer and a willing seller, neither being under compulsion to buy or sell and both having reasonable knowledge of relevant facts.

Generally, 18 U.S.C.S. §§ 2031-2034; Sec. 20.2031-1(b), Federal Estate Tax Regulations.

In the past, oil and gas valuations have been based upon factors such as the reported annual income derived from the interests, market prices for crude oil, oil and gas content, fragmented interests of the leaseholder, transportation costs, the time value of money, holder's internal rate of return and the oil industry's "barrel of oil equivalent (BOE)" figures. J. Smith, T.C. Memo. 1993-236.

Here, no deep wells were ever drilled. Consequently, under almost any common evaluation factor used by the Department or the Internal Revenue Service, the deep gas interests had no ascertainable value at Taxpayer's death. Therefore, the assets should be reported on a Pennsylvania Inheritance Tax return, Schedule E, with a value of \$0. Shallow gas production began on March 12, 1981. Taxpayer died on July 23, 1981. Therefore, the Decedent's interest in the shallow gas should be valued and included on the Decedent's Pennsylvania Inheritance Tax return.