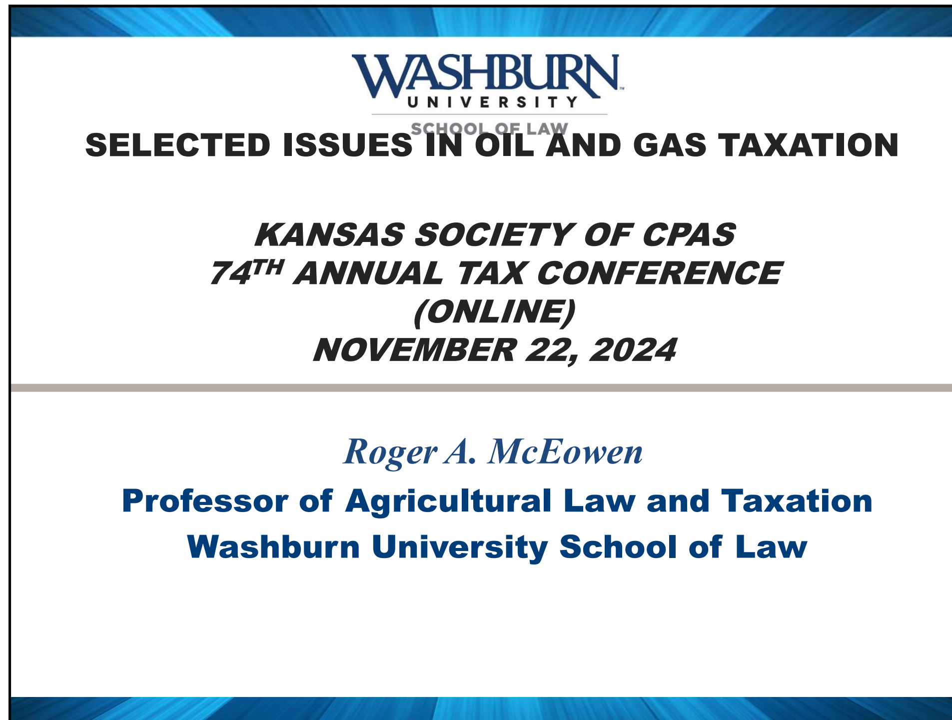

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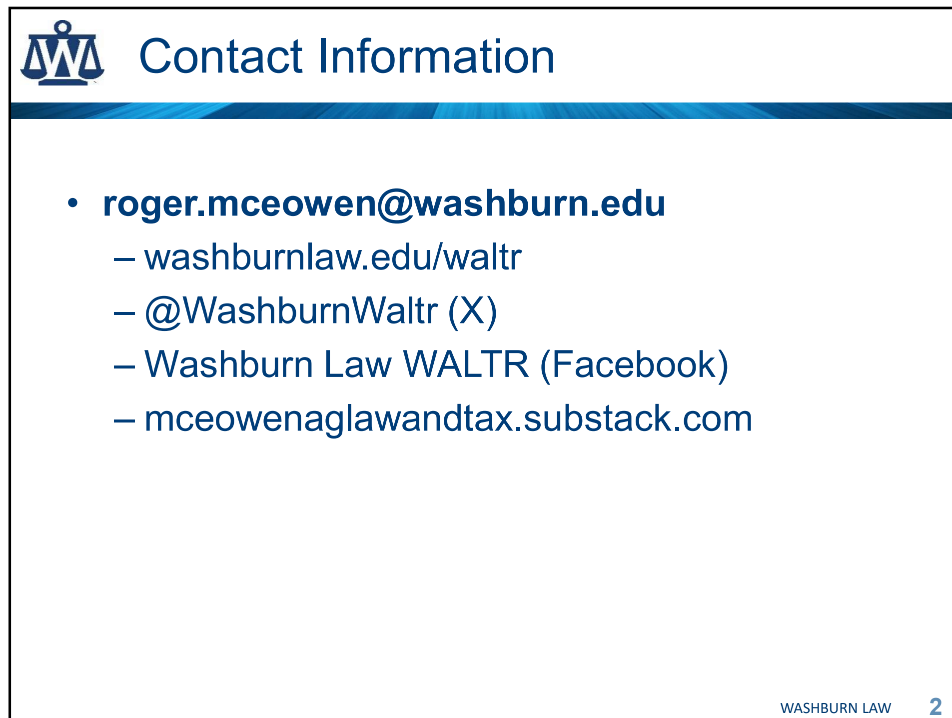

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Oil and Gas Tax Update

WASHBURN LAW 3

3

Overview

- **Various types of payments**
- **Two new taxes effective 1/1/13**
  - The I.R.C. §1411 passive tax
  - 0.9% Medicare tax (active)
- **Common features of leases**
  - Initial period and then production period
- **Division of income**
  - Mineral interest owner (royalty owner)
  - Operator (working interest owner)

4

Working Interest Owner

- **The working interest owner bears the entire cost of exploration for minerals, as well as the development and production costs.**
  - The royalty owner bears none of the exploration, development, or operational costs.
- **The funding necessary for the working interest owner to develop the oil and gas property is provided by investors who receive an interest in the activity in exchange for their capital investment.**
  - The costs of the activity borne by the working interest owner are allocated to the investors.
    - These include geological survey costs, tangible costs (the drilling equipment and well), and intangible drilling costs (IDC).
      - These costs can be currently deducted rather than capitalized.

WASHBURN LAW 5

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Working Interest Owner & Investors 2

- **The relationship between the working interest owner and the investors is typically a joint venture that is classified as a partnership for tax purposes.**
  - The partnership passes through the costs separately to the investors on Schedule K-1.
  - In the early years of the activity, the partnership typically passes through large losses to the partners.
    - Because the partners are merely investors in the activity, the losses in their hands are passive losses.
      - Limited under the passive loss rules and only deductible to the extent the investor has passive income.

WASHBURN LAW 6

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Investment in Oil and Gas Activity Triggered S.E. Tax

2

- *Methvin v. Comr., T.C. Memo. 2015-81 [aff'd by 10th Cir. on Jun. 24, 2016]*
  - Taxpayer invested in oil and gas interests
  - Normally, investment income would not be s.e. taxable, but court said that the operating agreement created a partnership and generated partnership income under agency principles
    - S.E. tax applied even though the taxpayer took no part in management or operation of the ventures
    - Election out of Subchapter K does not change the nature of the entity
    - IRS can pursue an issue that it conceded in a prior year

7

Lease Bonus Payment

- **An amount paid (usually per acre) to acquire an economic interest in minerals.**
- **Must be payable in all events with no conditions precedent or subsequent to subvert the payments.**
- **Lessor reports on Schedule E as ordinary income flowing to the 1040**
  - Example 1

8

Tax Consequences of Bonus Payments

- **Lessee: Must be capitalized as leasehold acquisition costs.**
  - May be subject to cost depletion
- **Lessor: Must report ordinary income.**
  - Treated as an advanced royalty
  - Not subject to percentage depletion
  - However, the lease bonus may be subject to cost depletion. See Reg. § 1.612-3(a).

9

The *Dudek* Case – Lease Bonus

- **The depletion issue**
  - I.R.C. §613A(d)(5)
    - A percentage depletion deduction for income from oil and gas wells does not apply to "any lease bonus, advance royalty, or other amount payable without regard to production from the property"
  - Petitioner's bonus payment was paid to induce him to enter into the lease agreement and was not related to any extraction or production of oil and gas
  - Court noted, however, that bonus payments are eligible for cost depletion via Treas. Reg. §1.612-3(a)(1), with the amount being dependent on the taxpayer's basis for depletion, the amount of the bonus payment and the future royalties the taxpayer expects to receive.
    - Here, petitioner didn't have any evidence as to the amount of royalties he expected to receive. Thus, cost depletion couldn't be computed.

10

The *Dudek* Case – Bonus Payment

- **Tax Court**
  - Noted that U.S. Supremes had long ago ruled that the receipt of a bonus payment by a lessor is ordinary income
    - *Burnett v. Hamel, 287 U.S. 103 (1932)*
  - Lease vs. sale analysis
    - The key is whether the lessor retains an economic interest in the deposit. If so, it's a lease and the proceeds are ordinary income
      - Here, the petitioner was entitled to a royalty of 16 percent of the net profits of any oil or gas extracted. That gave the petitioner an economic interest in the minerals in place

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Questions from *Dudek*

- **How does a lessor establish a separate "basis" for mineral rights when the land and minerals are purchased together in a single transaction?**
  - Many buyers don't allocate cost basis to mineral rights when they are acquired in the same transaction with the land
  - This could create a big problem!

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Estimated Future Royalties on Wildcat Acreage

3-4

- **Issue not addressed by *Dudek:***
  - Can you claim a 100% cost depletion deduction in situations where a zero estimate of future royalties to be received in the future is reasonable?
    - Yes. Collums v. United States, 480 F. Supp.864 (D. Wyo. 1979)
      - A zero estimate of future royalties was reasonable where the lease was in a wildcat area and where there was no evidence to indicate there would be future production during the lease term. Court applied the formula in the Treas. Regs. to allow cost depletion deduction in year of receipt of lease bonus equal to the entire basis in the lease. But…

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Service Position on 100% Cost Depletion

Cost Depletion on Wildcat Acreage

If a taxpayer (landowner) receives a lease bonus on wildcat acreage and claims cost depletion equal to 100 percent of it cost, this has the effect of claiming that the minerals are worthless as they supposedly will produce no future income (i.e., no mineral deposit exists).

Worthlessness must be proven by an identifiable event, and in this case, no such event has occurred. Further, it is assumed that the lease itself has value or the lessee would not have paid the bonus. Therefore, cost depletion should not be allowed unless it is possible to make a reasonable estimate of future income and that estimated income is not zero.

See also, TAM 8532011 (May 7, 1985)

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Any Way Around the Problem Presented by the IRS?

- **Consider the following:**
  - Before entering into negotiations with oil company, separate out an overriding royalty interest from the working interest and transfer the overriding royalty interest to a separate related party for a business reason.
  - Then negotiate similar deal with oil company and transfer entire working interest to the oil company
  - Bottom line:
    - Oil company gets the working interest “subject to” the pre-existing overriding royalty interest that the related party holds
    - Stronger case for “sale” rather than “lease” – no retained economic interest in the oil and gas deposit by retaining a royalty. Instead, the taxpayer has disposed of the taxpayer’s entire interest in the minerals.
  - Step transaction??? Substance over form???
    - See FSA 1999-819

Bonus Payment

- **What if lessee deducts percentage depletion?**
  - Lessee’s depletable gross income from the property must be reduced by a proportionate part of the bonus paid
    - The reduction is part of the bonus payment paid in the tax year or prior years allocable to the product sold during the tax year.
    - Lessee reduces gross income from the property by amount of bonus payments paid for the lease

Bonus Payment Paid in Installments [5]

- **Paid annually for fixed number of years regardless of production and are not avoidable by lease termination**
  - Also consideration for granting lease
  - Lessee capitalizes the payments
  - Lessor has ordinary income equal to FMV of contract in year lease was executed (if right to income transferable)
    - If not transferable, cash basis lessor can defer recognizing payments until receipt.

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Separate Cost Basis in Minerals?

- **Internal Revenue Manual (4.41.1.2.1.2) (Dec. 3, 2013)**
  - There is no separate cost basis in the minerals unless:
    - The seller's cost included a stipulated amount for mineral rights;
    - The seller's basis was the result of an estate tax valuation in which minerals and the surface were valued separately; or
    - The seller's cost basis can be properly allocated between surface and minerals because of substantive evidence of value attributable to the minerals at the date of acquisition

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Delay Rental Payment

5

- **An amount paid for the privilege of deferring development.**
  - Is “pure rent” and is not a payment for oil
- **Must be avoidable**
  - This characteristic distinguishes a delay rental from a lease bonus payable in installments.
    - Abandonment
    - Commencement of development of operations

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Tax Consequences of Delay Rental Payments

- **Lessor**
  - Must report ordinary income
  - NII
  - Report on Schedule E, flowing to line 17 of 1040
- **Lessee**
  - The IRS position is that they must be capitalized as leasehold costs under I.R.C. §263A up to depletable basis
  - To extent not required to be capitalized, may deduct currently. Treas. Reg. §1.612-3
    - May be allowed to capitalize or deduct on an annual basis. I.R.C. §266
- **Example 2**

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Service Position on Delay Rentals

- **Reg. § 1.263A-2(a)(3). Treat delay rentals as preproduction costs and capitalize them to leasehold costs on the property.**
  - To the extent not required to be capitalized under Sec. 263A, can deduct or charge to a depletable capital account.
- **PLR 9602002. At least some delay rentals must be capitalized.**
- **Coordinated Issue Paper. (1997)**
- **Appeals Settlement Guideline. (2002)**

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Settlement Guidelines for Capitalization of Delay Rentals

1. **Capitalize those delay rentals paid for leases that are part of an area for which there was a comprehensive plan to explore and produce wells.**

2. **Capitalize those delay rentals paid for leases that are part of an area in which there has been G&G activity since acquisition, or for which there has been a purchase of G&G information.**

3. **Use taxpayer information to develop an historical production and pre-production rate for leases.**

22

Settlement Guidelines for Capitalization of Delay Rentals

4. **Take a "look-back" at what actually occurred. That is, deduction of delay rentals would be allowable in the year in which there was no further pursuit of production or pre-production activities for the particular lease area. This would be feasible since Appeals consideration would be well after the fact.**
5. **Historical lease abandonment rates of the taxpayer involved could be used to determine an appropriate write-off period for delay rentals, without regard to the particular lease involved.**
6. **Use of any other facts or factors, perhaps unique to the situation, which might indicate intent to develop or a lack thereof.**

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Bottom Line on Delay Rentals

- **Capitalize if:**
  - A taxpayer performs geological and geophysical surveys (G&G) on acquired leasehold, or
  - Files a plan of development with an appropriate governmental agency, or
  - Authorizes funding for the development of the lease

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Royalty Income

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- **Landowner royalty**
  - The right to the oil and gas or minerals in place that entitles the owner of a percentage of gross production free of expense of development and operations
    - A continuing non-operating interest
    - The royalty payment is a payment for oil and gas

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Royalty Payments

- **Tax consequences**
  - Lessor
    - Reports gross amount received
      - No reduction by any part of cost of rights under which royalties received or by any amount allowable as a deduction when computing gross income
      - Reported to lessor in Box 2 of Form 1099-Misc
      - May be subject to cost depletion
      - Include in NII

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Royalty Payments

- **Tax consequences to lessee**
  - Deductible
  - Payment of ad valorem taxes on mineral property by lessee is an additional royalty to lessor
    - To extent income from production covers the tax payment
      - Otherwise, it's additional rent not subject to depletion

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Advanced Royalties

- **Paid before production of minerals occurs**
  - Lessee must pay royalties on a specified number of units of minerals annually (extraction immaterial)
  - Lessee can apply amounts paid on account of units not extracted within the year against royalty on minerals extracted later; and
  - Payment is avoidable

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Advanced Royalties

- **Tax treatment**
  - Lessee
    - Deduct in year in which production is sold
  - Lessor
    - Ordinary income
    - No percentage depletion
    - Cost depletion in year payments are made

29

Advanced Minimum Royalties

7

- **In addition to conditions for advanced royalties, the contract requires a substantially uniform amount of royalties be paid at least annually over the life of the lease or for a period of at least 20 years.**

30

Advanced Minimum Royalties

- **Tax treatment**
  - Lessor
    - Same as advanced royalties
  - Lessee
    - Has option to deduct payments in year paid or accrued or when oil or gas is sold or recovered.

31

Shut-In Royalty

7-8

- **“Shut-in” means a well is turned off due to lack of market or marketing facilities**
  - Well remains capable of producing in commercial quantities
  - Lessee can deduct payment
  - Lessor has royalty income

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Damage Payments

- **Crop damage payments are ordinary income**
  - Treat as a sale of the crop
  - If, however, a portion represents damages to business goodwill, payment is non-taxable up to basis in the affected property, then taxable as §1231 gain.
- **Payment for anticipated damages (but where there are none), are ordinary income**

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Production Payments

- **Owner of oil and gas interest sells a specific volume of production from an identifiable property until a specified amount of money or minerals has been received**
  - Payable only out of working interests' share of production

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Production Payments

- **Types**
  - Retained production payments
  - Carved-out production payments

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Production Payments

- **Tax treatment**
  - Carved-out payment generally treated as a nonrecourse mortgage on the property
    - Lessee treats payment as repayment of principal and interest expense
    - Lessor treats payment as repayment of principal and interest income
      - No income at time transaction entered into

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Production Payments

- **If payment is for development of the property, or the payment is retained when the property is leased, payment is not an economic interest**
  - Ordinary income to lessor subject to cost or percentage depletion
  - Lessee capitalizes the payments

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Basics of Depletion Deduction

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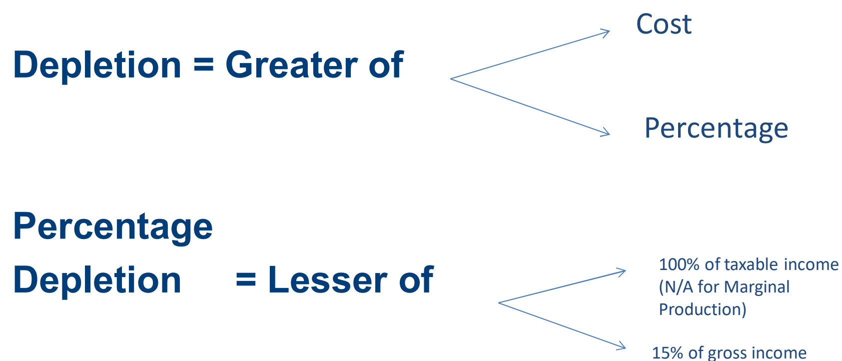

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Depreciation

14

- **Oil and gas property**
  - Normal MACRS rules
  - Typically, 7-year property
  - 200% declining balance method
  - Eligible for I.R.C. §179
  - Eligible for “bonus” depreciation
  - DPAD (6% of DPRG) [through 2017]

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Natural Gas Gathering Lines

- **New Statutory 7 Year Recovery Period**
- **Section 168(e)(3)(C)(iv) original use begins with the taxpayer**
- **Placed in service after April 11, 2005**

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Natural Gas Gathering Lines: Current Law

Natural gas gathering lines are treated as:

7 year property under MACRS by Taxpayers

- **Rev. Proc. 87-56, Asset Class 13.2**
- ***Duke Energy Natural Gas Corp., 10th Cir. 1999***
- ***Saginaw Bay Pipeline Co.,* 6th Cir. 2003**
- ***Clajon Gas Co. LP,* 8th Cir. 2004**
- ***and***

15 year property under MACRS by the IRS

- **Rev. Proc. 87-56, Asset Class 46.0**
- ***Duke Energy Natural Gas Corp., 109 T.C. 416***
- ***Saginaw Bay Pipeline Co.,* D. Mich.**
- ***Clajon Gas Co. LP,* 119 T.C. 197**

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Natural Gas Gathering Lines: New Law

New § 168(e)(3)(C)(iv) provides that any natural gas gathering line the original use of which commences with the taxpayer after April 11, 2005 is depreciable as MACRS 7 year property.

No AMT depreciation adjustment shall apply to property described in § 168(e)(3)(C)(iv), [§ 56 (a)(1)(B)]

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Natural Gas Gathering Lines: New Definition

A natural gas gathering line is defined in §168(i)(17) as:

(1) The pipe, equipment, and appurtenances determined to be a gathering line by the Federal Energy Regulatory Commission, and

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Natural Gas Gathering Lines: New Definition (Con't)

(2) The pipe, equipment, and appurtenances used to deliver natural gas from the wellhead or a common point to the point at which the gas first reaches either:

a) A gas processing plant,
b) An interconnection with a transmission pipeline for which a certificate as an interstate transmission pipeline has been issued by the Federal Energy Regulatory Commission,
c) An interconnection with an intrastate transmission pipeline, or
d) A direct interconnection with a local distribution company, a gas storage facility, or an industrial consumer (Code Sec. 168(i)(17), as added by the Energy Act).

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Natural Gas Gathering Lines

- **New Change in the Alternative Depreciation System Class Life**
  - Former law: 22 year class life. (Asset Class 46.0)
  - New law: 14 year class life. § 168(g)(3)(B)
- **No tax preference item for MACRS depreciation on natural gas gathering lines. §56(a)(1)(B)**

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Uncertainty May Continue

- **The new law will not apply to:**
  - Natural gas gathering lines placed in service prior to the effective date, or
  - Used gathering lines acquired after the effective date.

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Taxpayer's Argument

- **Taxpayers have taken the position that oil and gas gathering lines are included in Asset Class 13.2 of Rev. Proc. 87-56, and therefore have a recovery period of seven years.**
- **Asset Class 13.2 "includes assets *used by petroleum and natural gas producers* for drilling wills and production of petroleum and natural gas, *including gathering pipelines* and related storage facilities."**

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Taxpayer's Position

- **The controversy occurs in situations in which the gathering system is not owned by a producer, but instead is owned by an unrelated pipeline company.**
- **In these situations the pipeline company [the owner of the gathering pipeline] argues that as long as the gathering pipelines are used by petroleum and natural gas producers [non-owners] for the production of oil and gas from the underground formation, the gathering pipelines belong in Asset Class 13.2 with respect to the pipeline company.**

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Service's Position

- **The government consistently takes the position that the gathering lines of pipeline companies belong in Asset Class 46.0 of Rev. Proc. 87-56, and have a recovery period of fifteen years.**
- **Asset Class 46.0 "includes assets used in the private, commercial, and contract *carrying of petroleum, gas and other products* by means of pipes and conveyors.**
- **The government argues that the gathering line must be owned by a producer in order to qualify for Asset Class 13.2.**

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Plain Language Argument

- **Thus, the specific language in Asset Class 13.2 was materially and substantively modified, even though Section 1.04 of the Rev. Proc. 77-10 states that no change to the asset class was intended by the drafters.**
- **It is also plain to see that that language requiring the producer to own the gathering lines was omitted in this description in Rev. Proc. 77-10.**
- **Here the seekers of intent must make a decision: Does it mean what it was? Or Does it mean what it says?**

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It Means What it Says

- **Three Circuit Courts of Appeal have held it means what it says!**
- **Taxpayers have successfully taken MACRS deductions based on a 7 year recovery period.**

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Natural Gas Distribution Lines

- **New 15 year Statutory Recovery Period**

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Natural Gas Distribution Lines

- **Former Law:**
  - Natural gas distribution lines were treated as 20 year property under MACRS
    [Rev. Proc. 87-56, Asset Class 49.21]
  - New law:
    - § 168(e)(3)(E)(viii) provides that any natural gas distribution line **the original use of which commences with the taxpayer after April 11, 2005 and before January 1, 2011, is depreciable as MACRS 15 year property.**

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Natural Gas Distribution Lines

- **Provision not to apply to used gas distribution lines**
  - Used gas distribution lines purchased as an asset from an existing business or
  - Received as an asset in connection with a taxable acquisition of an existing business
- **Binding contract exception is applicable**

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Natural Gas Distribution Lines

- **No Change in the Alternative Depreciation System Class Life**
  - Former law: 35 year class life.
  - New law: 35 year class life. § 168(g)(3)(B)
- **No tax preference item for MACRS depreciation on natural gas distribution lines. § 56 (a)(1)**

55

Uniform Capitalization Rules

15

- **Rev. Rul. 68-226**
  - An oil and gas leasehold is an interest in real property
  - Mineral interest is real property
- **This means that a taxpayer who acquires and develops oil or gas properties is engaged in a developmental activity as defined by I.R.C. §263A**

56

UNICAP Rules

- **Predevelopment expenses**
  - Can't distinguish from intangible drilling costs
    - IDCs are not subject to the UNICAP rules
  - Exploration is a separate activity from development and production

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Mineral Rights and Conservation Easements

17

- ***North Donald LA Property* (2024)**
  - The perpetuity requirement
  - Carefully draft deed

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THANK YOU!

- **Contact Information**
  - roger.mceowen@washburn.edu
    - www.washburnlaw.edu/waltr
    - @WashburnWaltr (X)
    - Washburn Law WALTR (Facebook)
    - Mceowenaglawandtax.substack.com

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