

TAX ASPECTS OF ACQUISITIONS AND DISPOSITIONS  
OF OIL AND GAS PROPERTIES:  
PART I – INDIVIDUAL PROPERTIES

JAMES R. BROWNE  
STRASBURGER & PRICE, LLP  
DALLAS TEXAS

**Introduction**

This article discusses certain federal income tax considerations relevant to the purchase or sale of oil and gas properties. Part 1 presents general concepts and tax considerations in transactions involving individual properties, as opposed to transactions involving the purchase and sale of all of the properties comprising an active business. Part 2, to be published in the next edition of this journal, will discuss the tax considerations relevant to the purchase of an operating oil and gas business, including a purchase of assets and a purchase of stock or other equity of the entity that operates the business.

**General Concepts**

**Economic Interest**

One of the key concepts in oil and gas taxation is whether the seller or buyer has an “economic interest” in oil and gas (“minerals”) in place (“reserves”). Only an owner of an economic interest in the reserves is entitled to depletion deductions against income from the production of the reserves. In addition, if a seller grants an interest in reserves but retains a nonoperating economic interest in the reserves (such as a sale of the working interest with a retained royalty), the seller is generally treated as having entered into a lease of the reserves and not a sale, and therefore the seller is not eligible for capital gain on the proceeds of the transaction.

An economic interest is defined as follows:

An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in the mineral in

place...and secures, by any form the extraction of the mineral or severance of the timber, to which he must look for a return of his capital.<sup>1</sup>

Examples of economic interests include a working interest held as lessee or sub-lessee under a lease, a royalty interest retained by a landowner upon execution of a lease of the reserves, an overriding royalty interest retained by a lessee or other owner of an interest in the reserves, and a net profits interest. Each of these interests can be recovered only from the production of the reserves.

A production payment (a right to receive payments from production of the reserves that does not extend for the entire economic life of the reserves) is an economic interest in the reserves, but in certain cases it is classified as a mortgage loan for tax purposes and does not have the tax consequences normally associated with an economic interest.<sup>2</sup> Production payments are discussed in more detail later in this article.

A right to payments that can be satisfied other than from production of the reserves (e.g., from other assets of the grantor of the interest) is not an economic interest in the reserves. For example, a production payment that can be satisfied from a sale of the grantor's fee interest in the land containing the minerals is not an economic interest in the reserves.<sup>3</sup>

### **Lease versus Sale**

As noted above, the tax characterization of a conveyance of rights and obligations in oil and gas reserves can have important implications for the transferor's qualification for favorable capital gains tax rates on the proceeds of the conveyance and on the transferor's ability to claim depletion deductions against the proceeds. The principal distinction is between a lease of the minerals and a sale of the minerals.<sup>4</sup>

---

<sup>1</sup> Treas. Reg. § 1.611-1(b)(1).

<sup>2</sup> See I.R.C. § 636.

<sup>3</sup> *Anderson v. Helvering*, 310 U.S. 404 (1940).

<sup>4</sup> For additional discussion of types of conveyances, see Noah S. Baer, *Oil and Gas Transactions*, BNA Tax Mgmt. Portfolios #605-2d, ¶ II(C) (2009)

### *Lease*

A transaction is classified as a **lease** if a mineral interest owner transfers all or a portion of the operating interest to a buyer and reserves a nonoperating economic interest in the severed portion that is expected to continue for the productive life of the property (e.g., a royalty). A **sublease** occurs when a lessee assigns an operating interest and retains a nonoperating economic interest (e.g., an overriding royalty interest). <sup>5</sup>

### *Sale or Exchange*

A transaction will be treated as a **sale or exchange** under three general circumstances:

1. The owner of any type of interest assigns all of his interest without retaining any economic interest (other than a production payment qualifying as a mortgage loan) in the interest assigned;<sup>6</sup>
2. The owner of any type of interest assigns a fractional interest identical, except as to quantity, with the fractional interest retained;<sup>7</sup> and
3. The owner of a working interest assigns any type of continuing nonoperating economic interest in the property and retains the working interest. <sup>8</sup>

---

(hereinafter “Baer”).

<sup>5</sup> *Crooks v. Commissioner*, 92 T.C. 816 (1989); *Hogan v. Commissioner*, 141 F.2d 92 (5<sup>th</sup> Cir. 1944).

<sup>6</sup> *Hammonds v. Commissioner*, 106 F.2d 420 (10<sup>th</sup> Cir. 1939) (conveyance of entire leasehold interest in exchange for cash consideration and an oil payment in a specified dollar amount).

<sup>7</sup> *Ratliff v. Commissioner*, 36 B.T.A. 762 (1937) (sale of one-half of the taxpayers’ royalty interest).

<sup>8</sup> *Cf.* G.C.M. 38907 (Oct. 14, 1992) (carved out net profits interest is not an assignment of income); G.C.M. 39181 (Mar. 6, 1984) (payment for carved out royalty is consideration for a sale of the royalty); Tech. Adv. Mem. 8248011

Note that if the proceeds of the sale had been used in the development of the property, the transaction would have been non-taxable under the “pool of capital” doctrine. See the discussion below under the heading “Sharing Arrangements.”

As an example of a sale transaction, assume B holds a 100% working interest (lease) in certain minerals. B transfers an undivided 75% working interest in the minerals to C in exchange for \$50,000 cash not used in the development of the property. This is a sale because it is a transfer of a fractional interest identical, except as to quantity, to B’s retained interest.

If instead B transfers an overriding royalty interest in the minerals to C in exchange for \$10,000 cash not used in the development of the property, the transaction is a sale because the overriding royalty interest is a continuing nonoperating interest in the property and B retains the working interest.

Compare the latter transaction (sale of a carved out overriding royalty interest) to a common transaction in which a developer or lease aggregator transfers a leasehold interest and *retains* an overriding royalty. For example, B transfers his entire working interest to C in exchange for \$50,000 cash not used in the development of the property plus a retained 1% overriding royalty interest. B might be surprised to learn that this is not a sale but is instead a sublease (because B has retained an economic interest in the property). B might be able to avoid sublease treatment by initially purchasing the overriding royalty interest in a separate transaction,<sup>9</sup> or by having a separate entity purchase the overriding royalty interest upon the transfer to C. Alternatively, B can avoid sublease treatment using a retained production payment and contingent royalty.<sup>10</sup>

---

(Aug. 31, 1982) (same).

<sup>9</sup> *Cf. Badger Oil Co. v. Commissioner*, 118 F.2d 791 (5<sup>th</sup> Cir. 1941) (taxpayer, owning the leasehold interest and a royalty interest in minerals, assigned the leasehold interest for a purchase price not dependent on production; held, the assignment) of the leasehold interest was a sale).

<sup>10</sup> See PLR 9437006. For additional discussion of retained production payments, see the discussion below under the heading “Sale with a Retained Production Payment.”

## Acquisition of Individual Properties

### Acquisition by Lease

By far the most common way to acquire an interest in oil and gas reserves is through a lease. In a typical lease transaction, a landowner grants the developer the right to explore for and develop the subsurface oil and gas reserves on the property in exchange for an up-front bonus payment payable without regard to production plus a retained royalty payment payable out of production. Because the landowner retains a royalty, the landowner is considered to have a retained economic interest in the minerals, and the transaction is classified for tax purposes as a lease rather than as a sale.

The tax consequences of this typical lease arrangement are as follows:

*Lessor's Tax Consequences.* The receipt of a lease bonus payment is ordinary income to the lessor.<sup>11</sup> The lessor can claim cost depletion deductions against the bonus payment based on the ratio of the lease bonus to the projected royalties.<sup>21</sup>

*Lessee's Tax Consequences.* The lessee's lease bonus payment is included in the lessee's depletable basis in the leasehold.<sup>13</sup> If production occurs, the lease bonus payment is recovered through depletion.<sup>14</sup> If the developer does not drill a producing well, or if the lease expires, any

---

<sup>11</sup> Rev. Rul. 69-352, 1969-1 C.B. 34.

<sup>12</sup> Treas. Reg. § 1.612-3(a)(1). Percentage depletion is not allowed for lease bonus payments that are payable without regard to production from the property. I.R.C. § 613A(d)(5). Royalties are eligible for percentage depletion. Landowners generally don't claim cost depletion against the lease bonus payment because of the difficulty of establishing the proper cost basis for the minerals and estimating total future royalties.

<sup>13</sup> Treas. Reg. § 1.612-3(a)(3).

<sup>14</sup> Treas. Reg. § 1.612-3(a)(3). For purposes of computing the lessee's percentage depletion deductions with respect to the property, the lease bonus payment is ratably excluded in determining gross income from the property. The payments are not otherwise excludible or deductible in computing gross income under I.R.C. § 61. Treas. Reg. § 1.613-2(c)(5)(ii).

unamortized bonus is deducted as an abandonment loss.<sup>15</sup> Royalty payments by the lessee to the lessor are excluded from the lessee's gross income.<sup>61</sup>

*Example 1:* Assume landowner L owns land with a basis of \$10,000. L executes a lease with developer D granting D the right to enter on the land and explore for and produce all subsurface oil and gas. D pays L a \$30,000 bonus on signing of the lease, and L retains a 1/8 royalty in any oil and gas production.

L has \$30,000 of ordinary income on receipt of the lease bonus.<sup>71</sup> Any royalties received by L are taxed as ordinary income, but can be reduced by percentage depletion deductions. D has a \$30,000 adjusted basis in the property. If D obtains production, the \$30,000 basis will be recovered through depletion over the life of the lease. Upon an expiration or abandonment of the lease, any unrecovered basis is deductible at that time. Any royalty paid by D is excluded from D's income from the property.

### **Alternatives to Up-front Lease Bonus Payments**

As indicated in the previous section, a typical lease bonus payment that is paid at the inception of the lease has unfavorable tax consequences. The lessee has immediate ordinary income, and the lessor has a deferred deduction (if any). Some alternatives to an up-front lease bonus payment are as follows:

#### *Increased Royalty*

In lieu of all or a portion of the a lease bonus payment, the developer could offer to pay the landowner an increased royalty payment. The royalty is excluded from the developer's income, and is included in the landowner's income, at the same time, and the landowner's royalty income can be offset by percentage depletion. So a royalty has a more favorable tax consequence.

---

<sup>15</sup> Treas. Reg. §1.165-1(a).

<sup>16</sup> Treas. Reg. § 1.613-2(c)(5)(i).

<sup>17</sup> This assumes the typical case in which L does not attempt to allocate any portion of his basis in the land to the minerals and claim cost depletion allocable to the bonus.

However, it is a different economic deal. A royalty payment is contingent on production, whereas a lease bonus is not.

#### *Deferred Bonus*

In lieu of an upfront lease bonus payment, the developer might offer to pay the lease bonus over time, and might even increase the total amount payable to reflect an implicit time value of money (interest) factor. A cash basis landowner might be able to recognize income only as the bonus is received, unless the deferred payment obligation is transferable and readily saleable.<sup>18</sup> This defers the landowner's tax liability, but does not address the underlying mismatch between the landowner's recognition of income and the developer's lack of a directly corresponding deduction.

#### *Minimum royalty*

Another alternative to a traditional lease bonus is a minimum royalty. A minimum royalty is defined as "A substantially uniform amount of royalties paid at least annually, either over the life of the lease (including extensions) or for a period of at least 20 years, in the absence of mineral production requiring payment of aggregate royalties in a greater amount."<sup>19</sup> In other words, a minimum royalty is a deferred bonus that offsets any royalties accruing on production.

*Example 2:* L grants D a five year oil and gas lease on a tract of land in return for a cash bonus of \$10,000 and L reserves a 1/8 royalty. D also agrees to pay a minimum royalty of \$10,000 per year during the life of the lease beginning with the second year and payable without regard to production. D may subtract from the 1/8 production royalty the cumulative minimum royalties previously paid. At the end of five years, the lease expires without any production having occurred.

---

<sup>18</sup> *Kleberg v. Commissioner*, 43 B.T.A. 277 (1941); Rev. Rul. 68-606, 1968-2 C.B. 42.

<sup>19</sup> Treas. Reg. §1.612-3(b)(3).

The landowner recognizes ordinary income as the minimum royalties are received. If the production royalty exceeds the minimum royalty, the entire amount is subject to percentage depletion. To the extent the minimum royalty exceeds the production royalty, the excess is not subject to percentage depletion as it is payable without regard to production.<sup>20</sup> The lessee can elect to deduct minimum royalties in the year of payment.<sup>21</sup> The deductions reduce the lessee's gross income from the property for purposes of computing the lessee's percentage depletion allowance.<sup>22</sup>

In the example above, L would recognize \$10,000 of ordinary income each year with no percentage depletion. D would deduct the minimum royalty payments each year. The result is that L's income and D's deductions match. However, the economics of the transaction are not the same as a \$50,000 lease bonus (payable over five years) and a 1/8th retained royalty because of the offset feature of a minimum royalty.

#### **Sale With a Retained Production Payment**

Several IRS private letter rulings suggest an alternative to a typical lease arrangement (upfront lease bonus payment plus retained royalty) that closely matches the economics of a lease, but with potentially much more attractive tax consequences for the landowner. In this alternative, the developer pays the landowner (a) an up-front payment equal to, but in lieu of, the lease bonus, (b) a retained fixed production payment equal to 1/8 of the production from the property up to 90% of the estimated total reserves at inception, and (c) a retained contingent production payment of 1/8 of any production in

---

<sup>20</sup> I.R.C. §613A(d)(5).

<sup>21</sup> Treas. Reg. §1.612-3(b)(3). Minimum royalty payments must be properly structured to qualify for a current year deduction. The IRS and the Tax Court have held that a minimum royalty payable in the form of a nonrecourse note is not a qualified minimum royalty. Rev. Rul. 80-73, 1980-1 C.B. 128; *Wingv. Commissioner*, 81 T.C. 17 (1977). According to the IRS, minimum royalty payments are not substantially uniform when based on a moving average of past production, because such a formula could give rise to wide variations. Rev. Rul. 79-381, 1979-2 C.B. 244. A minimum royalty formula adjusted for the consumer price index is permissible. Rev. Rul. 81-299, 1981-2 C.B. 138.

<sup>22</sup> Treas. Reg. §1.613-2(c)(5)(iii).

excess of the estimated total reserves at inception. The production payments are in lieu of the retained royalty under a lease.<sup>32</sup>

Under the retained production payment arrangement, the landowner receives substantially the same payments as under the lease, except that no royalty is paid on the last 10% of the estimated total reserves at inception. However, because the retained production payments are not considered an economic interest in the reserves, the transaction is considered a sale of the reserves rather than a lease. As a result, the tax consequences of this arrangement are materially different from the tax consequences of a traditional lease. The tax consequences of a sale with retained production payments are as follows:

*Landowner's Tax Consequences.* The upfront payment is treated as an amount realized from the sale of the minerals.<sup>24</sup> In computing the gain from the sale, the landowner should be able to allocate its tax basis for the land between the mineral interest and remainder interest based on the ratio of the estimated value of the payments under the sale transaction to the value of the remainder interest. The portion of basis allocated to the mineral interest can then be recovered against the upfront payments and the production payments according to the taxpayer's method of accounting. Assuming the minerals are a capital asset held for more than one year, the landowner's gain on the sale would be long-term capital gain eligible for a 15% maximum tax rate, a savings of 20 percentage points over the 35% maximum ordinary income tax rates. The net result should be less taxable income and a significantly lower tax rate.

---

<sup>23</sup> See, e.g., PLR 9437006. See also Rev. Proc. 97-55, 1997-2 C.B. 582 (ruling guidelines for production payments); *Cullen v. Commissioner*, 118 F.2d 651 (5<sup>th</sup> Cir. 1941) (transfer of working interest in exchange for upfront payment and retained oil payment was a sale). The landowner may also require payments equivalent to delay rental payments. Such payments should not affect the characterization of the transaction.

<sup>24</sup> I.R.C. § 636(b). But see *Watnick v. Commissioner*, 90 T.C. 326 (1988) (transfer for cash, plus reserved production payment, was not sale where there was no reasonable prospect that production payment would be fully paid during property's economic life).

Production payments received by the landowner will be treated in part as additional purchase price and in part as interest on deferred purchase price.<sup>52</sup> The interest component is calculated by discounting the payment back to the sale date using the “applicable federal rate” specified in the tax code, and treating the discount as interest.<sup>26</sup> Assuming the taxpayer reports gain from the transaction under the open transaction method,<sup>27</sup> the portion of each production payment treated as purchase price will give rise to long-term capital gain to the extent the cumulative amount received as upfront payments and as production payments exceeds the landowner’s tax basis.<sup>82</sup>

---

<sup>25</sup> I.R.C. §§ 636(b) (retained production payment treated as a purchase money loan), 1274 (imputed interest on debt issued for property), 483 (same for certain transactions to which I.R.C. § 1274 does not apply). Note that if the landowner were to retain an economic interest in the property (e.g., an overriding royalty interest), the transaction would not qualify as a sale, the lessee would treat the production payment (including any imputed interest component) as a deferred bonus, and the lessor would treat the production payment in the same manner as a royalty. I.R.C. § 636(c); Treas. Reg. § 1.636-2. *Cullen v. Commissioner*, 118 F.2d 651 (5<sup>th</sup> Cir. 1941).

<sup>26</sup> Treas. Reg. § 1.1275-4(c).

<sup>27</sup> *Burnet v. Logan*, 283 U.S. 404 (1931). The open transaction method is available only in those “rare and extraordinary cases” in which the fair market value of contingent payments is not reasonably ascertainable. Treas. Reg. § 1.1001-1(g). A volumetric production payment that is subject to discovery, extraction, volume, and price contingencies would seem to present a strong case for open transaction reporting.

<sup>28</sup> If Landowner does not report under the open transaction method, or if the open transaction method is held to be unavailable, gain from the transaction will be generally be reported under the installment method. *See* Treas. Reg. § 1.636-1(c)(4) (“gain realized on a transfer of a mineral property to which section 636(b) applies may be returned on the installment method under section 453”); Treas. Reg. § 15a.453-1 (election out of installment method). Under the installment method, basis would generally be allocated to each payment in proportion to the expected amount of each payment (exclusive of interest). Treas. Reg. § 15a.453-1(c)(6). An interest charge on the deferred tax liability is imposed where the aggregate face amount of all installment obligations from transactions involving a sales price of over \$150,000 (other than transactions involving for personal use property) arising during, and

*Developer's Tax Consequences.* The developer capitalizes the upfront payments as lease acquisition costs, and recovers the costs through depletion.<sup>29</sup> Unlike a lease bonus payment, the upfront payment under a sale transaction does not reduce the developer's gross income from the property (if any) for purposes of computing the purchaser's percentage depletion allowance.<sup>30</sup> If the property becomes producing, the developer must recognize in income 100% of the production from the property, and then treat the principal portion of production payments paid to landowner as additional acquisition costs to be recovered through depletion deductions.<sup>31</sup> The production payments do not reduce the developer's gross income from the property for purposes of computing the developer's percentage depletion allowance.<sup>32</sup> The portion of the production payments treated as interest are deductible by the developer subject to any applicable limitations on interest expense deductions.<sup>33</sup>

The net effect for the developer is not as favorable as for the landowner. If the developer is eligible for percentage depletion, the developer may be sacrificing the exclusion from income for the royalty payments under a lease arrangement, and getting little tax benefit from the production payments if cumulative percentage depletion deductions exceed cost basis. If the developer is claiming cost depletion, the disadvantages are less pronounced. In addition, the developer's tax disadvantages are somewhat mitigated if the property produces more than 90% of the estimated total reserves at inception,

---

outstanding at the end of, the taxable year exceed \$5,000,000. I.R.C. § 453A. In contrast, under the open transaction method, all payments received from Investor are first reported as a return of basis, and then as gain, and there is no interest charge on deferred tax.

<sup>29</sup> I.R.C. § 612.

<sup>30</sup> Because the landowner will not have depletable income with respect to the receipt of the upfront payment, the developer's depletable income should not be reduced on account of the payment. *Cf. Hammonds v. Commissioner*, 106 F.2d 420 (10th Cir. 1939) (holder of retained production payment not entitled to depletion). Regarding treatment of a lease bonus payment, see footnote 14.

<sup>31</sup> Treas. Reg. § 1.636-1(a)(1)(ii). *See* Treas. Reg. § 1.636-1(a)(3) Ex. 3.

<sup>32</sup> Treas. Reg. § 1.636-1(a)(1)(ii).

<sup>33</sup> I.R.C. § 163.

because the developer will owe no production payments on production in excess of 90% but not in excess of 100% of the estimated total reserves.

### **Installment Sales and Structured Sales**

To the extent the acquisition of an oil and gas property is characterized as a sale from the owner's perspective, and to the extent one or more payments for the property are due after the end of the taxable year of sale, the owner may be eligible to report the gain from the sale under the installment method.<sup>34</sup> Although a complete analysis of the tax considerations relevant to an installment purchase of oil and gas properties is beyond the scope of this paper, there are several significant drawbacks to an installment sale that should be noted:

- Basis is allocated among all installment payments rather than being applied in full against the first payments.
- Depreciation recapture is not deferred,<sup>35</sup> and intangible drilling costs and depletion recapture amounts are recognized before capital gain.<sup>36</sup>
- Large installment sales (greater than \$150,000 individually and \$5,000,000 in total) are subject to an interest charge on the deferred tax.<sup>73</sup>
- Borrowing against the installment obligation triggers deferred gain.<sup>38</sup>
- A disposition of an installment obligation will generally accelerate

---

<sup>34</sup> I.R.C. § 453.

<sup>35</sup> I.R.C. §§ 453(i).

<sup>36</sup> Treas. Reg. § 1.1254-1(d).

<sup>37</sup> I.R.C. § 453A(a)(1).

<sup>38</sup> I.R.C. § 453A(d).

any deferred gain.<sup>39</sup> An important exception is provided for certain liquidating distributions of installment obligations by an S corporation.<sup>40</sup>

If the buyer is not interested in participating in an installment sale, the seller may be able to structure an installment sale through an accommodation party that will hold the purchase price paid by the buyer and pay it out to the seller in installments. In one form of the transaction, the buyer purchases the property under a deferred payment arrangement, and immediately following the sale the buyer assigns its deferred payment obligation, and transfers the deferred purchase price, to an accommodation party (usually an insurance company affiliate). The accommodation party then uses the buyer's cash to purchase an annuity (usually from the accommodation party's insurance company affiliate) to secure the payments due to the seller under the installment payment obligation.<sup>41</sup>

Another widely advertised means of structuring an all cash sale as an installment sale is to sell the property to the accommodation party in an installment sale, and then have the accommodation party sell the property to

---

<sup>39</sup> I.R.C. § 453B. A gift of the deferred payment obligation is a disposition. Rev. Rul. 67-167, 1967-2 C.B. 107. A transfer of a deferred payment obligation, other than to the obligor/buyer, by reason of death is not a disposition. I.R.C. § 453(c). A distribution in complete liquidation to a 80% or more corporate shareholder under I.R.C. § 337(a) is not a disposition. I.R.C. § 453B(d). A transfer to a spouse incident to a divorce is generally not a disposition. I.R.C. § 453B(g). Certain other nonrecognition provisions may also override I.R.C. § 453B. See Treas. Reg. § 1.453-9(c)(2) (exceptions for transfers to corporations under I.R.C. § 351, transfers to partnerships under I.R.C. § 721, and transfers by a partnership to a partner under I.R.C. § 731). Although these regulations were promulgated under the pre-1980 version of the statute, they have not been revoked and are consistent with the intent of current I.R.C. § 453B. See Bittker & Lokken, *Federal Taxation of Income, Estates, and Gifts*, ¶ 106.1.13 (WG&L 2008), discussion at n.195.

<sup>40</sup> I.R.C. § 453B(h).

<sup>41</sup> For a discussion of these so-called "structured sales," see R. Wood, *Breathing Life into Installment Sales*, 108 Tax Notes 201 (2005).

the buyer.<sup>42</sup> The accommodation party would invest the sale proceeds in an annuity or other assets to fund its obligation under the installment payment obligation.

Each of these transactions is vulnerable to IRS attack under a variety of theories, including business purpose, form over substance, constructive receipt, and other theories, and should not be pursued without careful planning and assessment of business and tax risks.

### **Sharing Arrangements**

A developer wishing to acquire an economic interest in reserves might do so by contributing cash, property, or services to the acquisition, exploration, and development of the reserves. This transaction differs from a lease or a purchase in that the amounts paid by the developer are invested in the property rather than being paid to the landowner.

#### *Carried Interests*

A carried interest is generally defined as an arrangement in which one party (the "carrying party" ) agrees with the owner of an operating interest (the "carried party") to pay all of the cost to develop and operate a mineral property in exchange for the right to recoup this investment out of the proceeds from the first production from the property. After the investment is repaid ("payout"), any subsequent production is shared by the carrying party and carried party according to a predefined sharing ratio. The carried party is not obligated to pay for the development and operation until the carrying party's initial investment is repaid.<sup>43</sup> The carried party might retain an overriding royalty interest in the property during payout, with the right to convert the overriding royalty interest to an operating interest after payout.<sup>44</sup>

---

<sup>42</sup> See, [http://www.nafep.com/sdis/self\\_directed\\_installment\\_sale.htm](http://www.nafep.com/sdis/self_directed_installment_sale.htm).

<sup>43</sup> See *Internal Revenue Manual*, § 4.41.1.2.4.6.4 (Oct. 2005). If the carrying party is obligated to continue pay all the operating costs after payout and throughout the life of the lease, the carried party's interest after payout is essentially a net profits interest.

<sup>44</sup> See, e.g., Rev. Rul. 70-336, 1970-1 C.B. 145; See Michael L. Covey Jr., *Documenting the Oil and Gas Farmout Agreement*, 76 Okla. Bar J. 1101

Because the carrying party owns the entire operating interest in the minerals until payout, the carrying party can deduct all of the intangible drilling costs incurred in drilling the well, and can capitalize and depreciate all equipment costs associated with the lease and well. The carrying party is taxable on all net profits from the well prior to payout, and is eligible for depletion in accordance with its economic interest. Any overriding royalty interest retained by the carried party is not income to the developer, and the carried party can claim depletion against the overriding royalty income. After payout, the carrying party must capitalize as leasehold acquisition costs (recoverable through depletion) the portion of the remaining undepreciated basis of equipment equal to the operating interest acquired by the carried party after payout.<sup>54</sup>

#### *Farmout Arrangement*

A farmout arrangement is a carried interest arrangement in which the carrying party agrees to contribute services and materials to the development of the property as part of its undertaking to fund the development of the property. The issue raised by this type of arrangement is whether the carrying party (“developer”) recognizes income by reason of receiving an operating interest in the property in exchange for services and property.<sup>64</sup>

If the developer’s contribution is used exclusively in the development of the property, the lessee does not realize any taxable income from the developer’s contributions to the property, and the developer does not recognize any taxable income from the receipt of the economic interest in exchange for his contributions. The transaction is not viewed as a transfer of property (the economic interest) as compensation for the developer’s services or as payment for materials. Rather, the developer is treated as contributing his services and materials to the “pool of capital” comprising the project.<sup>47</sup> To

---

(May 14, 2005).

<sup>45</sup> Rev. Rul. 69-332, 1969-1 C.B. 87; Rev. Rul. 71-207, 1971-1 C.B. 160.

<sup>46</sup> See I.R.C. § 83 (transfer of property in connection with the performance of services); Treas. Reg. § 1.61-6 (gains derived from dealings in property).

<sup>47</sup> *Palmer v. Bender*, 287 U.S. 551 (1933); G.C.M. 22730, 1941-1 C.B. 214; Rev. Rul. 77-176, 1977-1 C.B. 77.

come within this pool of capital doctrine, the economic interest acquired must be in the same property to which the materials and services are contributed.<sup>84</sup>

Note that if the services are not part of the investment in the acquisition, exploration, or development of the oil and gas reserves, the receipt of an economic interest in the reserves will not be tax free under the pool of capital doctrine.<sup>49</sup> The Service narrowly construes the pool of capital doctrine as applied to services that are not directly related to the acquisition, exploration, and development of specific properties.<sup>50</sup>

#### *Fractional Interest Rule*

If, under a carried interest arrangement (including a farmout), the carrying party (“developer”) is not entitled to “complete payout” of all of its costs of developing the property (including operating costs up to the point of complete payout) prior to reversion of the carried party’s operating interest in the property, then the developer may deduct only the fraction of costs attributable to its permanent operating interest, and the fraction of the costs of equipment and intangible drilling costs attributable to the operating interest held by the carried party must be capitalized by the developer as leasehold

---

<sup>48</sup> Rev. Rul. 77-176, 1977-1 C.B. 77 (grant of interest in lands adjoining a drill site treated as taxable payment of compensation).

<sup>49</sup> *James A. Lewis Eng’r, Inc. v. Commissioner*, 339 F.2d 706, 709 (5th Cir. 1964) (receipt of a production payment as consideration for engineering services associated with production was taxable). Although the court held that the services were outside the scope of the pool of capital doctrine, it expressed “great difficulty accepting a construction of the Code that would fly in the face of the general provisions of the tax laws to the effect that compensation for services [is taxable].”

<sup>50</sup> Rev. Rul. 83-46, 1983-1 C.B. 16 (royalty received for services in locating or acquiring leases, or in supervising development, is not eligible for non-recognition).

acquisition costs.<sup>51</sup> The carried party may not deduct any of those costs because it did not fund them.<sup>52</sup>

*Example 3:* D agrees to pay all the costs of drilling and completing a well on a property owned by L in exchange for 65% of the working interest. A can elect to deduct only 65% of the intangible drilling costs.

*Example 4:* D agrees to pay all of the costs of drilling and completing a well on a property owned by L for 100% of the working interest until the end of the complete payout period. L retains a 1/16 overriding royalty in the property and has the option to convert such royalty to 25% of the working interest if payout has not occurred within 3 years. D can deduct only 75% of the intangible drilling costs, even if payout occurs within 3 years and even if L does not exercise its option.

It may be possible to avoid the adverse effects of the fractional interest rule using a tax partnership with special allocations. The partnership would own the entire operating interest at all times (before and after payout), and could specially allocate deductions entirely to the carrying partner according to his economic risk for those costs. If the well is producing, income and expenses associated with the well could then be allocated to the partners according to their sharing ratios.<sup>35</sup>

---

<sup>51</sup> Treas. Reg. §1.612-4(a)(3); Rev. Rul. 71-206, 1971-1 C.B. 105; Rev. Rul. 80-109, 1980-1 C.B. 129. A right to receive complete payout plus an additional amount followed by a reversion of the entire operating interest to the lessee will be regarded as a right to complete payout. Rev. Rul. 75-446, 1975-2 C.B. 95.

<sup>52</sup> *Marathon Oil Co. v. Commissioner*, 838 F.2d 1114 (10<sup>th</sup> Cir. 1987) (“the party who bears the economic risks associated with the operating interest in an oil and gas lease must also be entitled to claim the deductions associated with that interest.”).

<sup>53</sup> See Baer, *supra* n.4, ¶ VI(A)(4).

*Carved Out Production Payments*

As an alternative to a farmout (where the developer drills for an operating interest) or other carried interest arrangement (developer contributes cash for an operating interest), the developer might consider contributing cash to the landowner or lessee in exchange for a non-operating economic interest in the property, specifically a production payment. A “production payment” is “a right to specified share of the production from mineral in place (if, as, and when produced), or the proceeds from such production [having] an expected economic life (at the time of its creation) of shorter duration than the economic life of one or more of the mineral properties burdened thereby... A production payment may be limited by a dollar amount, a quantum of mineral, or a period of time.”<sup>54</sup>

A right to production payments that is granted by the landowner or a holder of a mineral lease is generally treated as a secured loan. The landowner or lessee (“grantor”) treats the consideration received for the production payment as proceeds of a loan, and treats the production payments as payments of principal and interest in accordance with generally applicable tax rules.<sup>55</sup> The grantor is entitled to all deductions associated with the development of the property that are funded from the consideration received for the production payments. The grantee likewise reports the receipt of the production payments as payments of principal and interest on a loan. Although a production payment is an economic interest in the minerals in place, the grantee is not permitted to claim depletion with respect to the receipt of the production payments.<sup>56</sup>

An exception is provided if the amount received by the grantor as consideration for the production payment is pledged for exploration or development of the property and the transaction is within the pool of capital doctrine.<sup>57</sup> In such a case, the receipt of the consideration and issuance of the rights to production payments is not a taxable transaction, any subsequent payments of production payments are excluded from the grantor’s gross

---

<sup>54</sup>Treas. Reg. § 1.636-3(a)(1); Rev. Proc. 97-55, 1997-2 C.B. 582.

<sup>55</sup> See I.R.C. § 1274, Treas. Reg. § 1.1275-4(c).

<sup>56</sup> Treas. Reg. § 1.636-1(a)(3), Ex. (1).

<sup>57</sup> I.R.C. § 636(a); Treas. Reg. § 1.636-1(b).

income from the property, and are included in the grantee's gross income from the property. The grantee treats the consideration for the production payment as an investment in the property, and is entitled to his share of deductions for development costs and to depletion deductions against production payments received. The grantor excludes the production payments from the grantor's gross income from the property and is not entitled to deductions for development costs and depletion allocable to the grantee.

### **Like-kind exchanges**

#### *In General*

A developer seeking to acquire an economic interest in specific oil and gas properties might be able to enhance the prospects of acquiring the interest if the transaction can be structured so that it is not currently taxable to the mineral interest owner (seller). One way to defer recognition of income is through a like-kind exchange.<sup>58</sup>

In a like-kind exchange, property held for productive use in a trade or business or for investment ("relinquished property") is exchanged for property of like kind which is to be held either for productive use in a trade or business or for investment ("replacement property").<sup>59</sup> If, in addition to qualifying replacement property, the seller receives cash or other non-qualifying property ("boot"), gain is recognized on the transaction to the extent of the value of the boot. In addition, if the relinquished property is property with respect to which intangible drilling costs or depletion has been claimed, the gain realized on the transaction (without regard to the like-kind exchange nonrecognition rule) must be recognized as ordinary income to the extent of (a) the gain recognized with respect to boot, plus (b) the fair market value of any qualifying property received in the exchange that is not "natural resource recapture property."<sup>60</sup>

---

<sup>58</sup> See generally David P. Goad and J.F. "Jack" Howell, III, *Section 1031 Like-Kind Exchanges – Deferred Exchanges of Oil, Gas, and Other Mineral Properties*, 68 Tex. Bar J. 824 (Oct. 2005).

<sup>59</sup> I.R.C. § 1031(a).

<sup>60</sup> Treas. Reg. § 1.1254-2(d). Natural resource recapture property includes any property if intangible drilling costs or certain other mining costs have been

Economic interests in reserves constitute real property interests and can generally be exchanged for other real property interests, including real property interests that do not constitute mineral interests. Therefore, an exchange of a producing oil lease for a fee interest in a ranch constitutes a like-kind exchange.<sup>61</sup> However, if relinquished property constitutes a developed interest in mineral reserves and the replacement property is not a similar interest, the recapture of prior intangible drilling costs and depletion deductions cannot be deferred.

#### *Deferred Like-Kind Exchanges*

If a developer wishing to acquire an economic interest in seller's property in a like-kind exchange was required to acquire the replacement property and deliver it to the seller directly, the transaction would have limited utility. Fortunately, the tax law allows a more flexible approach. The parties are able to structure the transaction as (1) a purchase by the developer of the seller's economic interest for cash, followed later by (2) a purchase by the seller of replacement property of the seller's choosing. If the transaction is structured through a qualified intermediary that holds the cash during the period between the two steps, and provided the seller satisfies a 45-day period for identifying the replacement property and a 180 day period for actually acquiring the identified replacement property, the transaction can qualify as a deferred like-kind exchange.<sup>26</sup>

---

charged to such property or if adjustments for depletion have been claimed with respect to the basis of the property. Treas. Reg. § 1.1254-1(b)(2).

<sup>61</sup> Rev. Rul. 68-331, 1968-1 C.B. 352.

<sup>62</sup> Treas. Reg. § 1.1031(k)-1.

*Like-Kind Exchanges Involving Partnerships*

Mineral interests are frequently held in entities classified as partnerships for federal income tax purposes. Partnerships can enter into like-kind exchanges, including deferred like-kind exchanges, with respect to property owned by the partnership.<sup>63</sup> However, a partnership interest cannot be qualifying property in a like-kind exchange.<sup>64</sup> If the seller holds oil and gas property through a partnership, the buyer cannot acquire the seller's partnership interest and still achieve a like-kind exchange. Short of having the partnership effect a like-kind exchange, what are the alternatives?

If a partnership holds property that the buyer wants to acquire as replacement property, the buyer can acquire all of the interests in the partnership. This is not treated as an exchange of relinquished property for partnership interests because the partnership either terminates as a result of the acquisition transaction, or the partnership becomes a disregarded entity. For example, in Ltr. Rul. 200807005<sup>65</sup> the taxpayer sold relinquished property through a qualified intermediary (QI) and the QI used the proceeds to purchase all of the partnership interests of Partnership (P), which held replacement property. QI then distributed the limited partner interests in P to the taxpayer, and the general partner interests in P to an LLC wholly owned by the taxpayer. Following the transaction, the acquired partnership and the LLC holding the general partnership interest were classified as disregarded entities for federal income tax purposes, and therefore the

---

<sup>63</sup> I.R.C. § 703(a) (requiring that partnership taxable income be separately computed); I.R.C. § 702(a) (partnership items to be separately stated, including gains or losses from sales or exchanges of capital assets and other property used in a trade or business).

<sup>64</sup> I.R.C. § 1031(a)(2)(D). An exception is provided if the partnership has elected out of subchapter K and is therefore treated as a passive co-ownership arrangement. I.R.C. § 1031(a)(2) (last sentence). *Cf.* Rev. Proc. 2002-22, 2002-1 C.B. 733 (ruling guidelines for undivided fractional interests in real property, other than mineral properties).

<sup>65</sup> Feb. 15, 2008.

taxpayer was treated as holding the replacement properties directly. The IRS ruled that the taxpayer's receipt of the partnership interests from QI was treated as the receipt of property held by the partnership for purposes of the like-kind exchange rules.

If a partnership holds property and one or more partners want to dispose of their partnership interests in a like-kind exchange, a "drop and swap" transaction might be considered.

*Example 5:* Partnership has three equal partners, Jerry, Kramer and George. The partnership holds a single piece of property as business or investment property. Jerry wishes to sell his interest in the partnership and use the proceeds to invest in like-kind property. Jerry cannot sell the partnership interest in a like-kind exchange transaction. Can Jerry instead have the partnership distribute an undivided 1/3 interest in the partnership's property to him tax-free, and then use the direct interest in the partnership property to effect a like-kind exchange?

A drop and swap transaction is also frequently considered when the partnership is selling partnership properties in a taxable sale and some, but not all, partners want to reinvest the proceeds in like-kind property. In lieu of taking a distribution of the taxable proceeds of the partnership's sale and reinvesting on an after-tax basis, the partners desiring a like-kind exchange might request an in-kind distribution of an undivided interest in the property in advance of the sale. The sale would then involve a taxable sale of the partnership's undivided interest plus a tax deferred sale of the distributee partners' respective undivided interests.

The success of a drop and swap transaction depends heavily on whether the formalities of the transaction are observed. *Chase v. Commissioner*<sup>66</sup> presents a good example of a case in which the formalities were not observed. In that case, the taxpayer, a partner in JMI partnership, had JMI distribute to the taxpayer the taxpayer's 46% undivided interest in property held by the partnership. The taxpayer then purported to transfer the 46% undivided to a trust. Shortly thereafter, JMI sold the property and a portion of the proceeds of the sale were paid to the trust. The trust then used the proceeds to acquire,

---

<sup>66</sup> 92 T.C. 874 (1989).

and transfer to the taxpayer, replacement property. The taxpayer claimed that the transfer of its 46% undivided interest to the trust followed by the trust's distribution of replacement property to the taxpayer constituted a like kind exchange. Contrary to the intended form of the transaction, none of the parties to any of the transactions observed the formalities associated with the taxpayer's ownership interest in the relinquished property. JMI negotiated all aspects of the transaction, absorbed all of the expenses of the properties and of the sale and purchase transactions, and received all of the income from the properties; the buyer was unaware of the taxpayer's ownership interest and contracted solely with JMI. The allocation of the sale proceeds did not follow the taxpayer's alleged ownership interest, but instead followed the partnership allocation provisions, suggesting that the proceeds were first paid to the partnership and then distributed to the taxpayer. The partnership agreement prohibited distributions of partnership property other than cash, and there was no evidence that the other partners authorized the distribution. These and other facts led the Court to conclude that, in substance, JMI disposed of the property on its own behalf, and not as an agent for the taxpayer, and JMI did not meet the requirements for a like-kind exchange.

Even if the formalities are strictly observed, the IRS could still contend that the transaction does not qualify for like-kind exchange treatment. For example, if the distribution of the partnership property (relinquished property) to the exchanging partner(s) occurs shortly before the closing of the sale of the relinquished property, the IRS could argue that the exchange of the relinquished property by the distributee partners does not qualify for like-kind exchange treatment because the distributee partners held the relinquished property solely for the purpose of disposing of it, and therefore the relinquished property was not, in the hands of the partner, "held for investment or productive use in a trade or business" as required by the statute. Several court decisions reject the notion that the relinquished property must be held for some minimum period of time without any intent to dispose of the property before the exchange can qualify for like-kind exchange treatment.<sup>67</sup>

---

<sup>67</sup> See, e.g., *Bolker v. Commissioner*, 760 F.2d 1039 (9th Cir. 1985) (property received in corporate liquidation with intent to exchange the property, and exchange effected three months later; held, "the intent to exchange property for like-kind property satisfies the holding requirement, because it is *not* an intent to liquidate the investment or to use it for personal pursuits).

However, a seller is well advised to put as much time as possible between the drop transaction and the swap transaction.<sup>68</sup>

Another potential ground for IRS challenge of a drop and swap transaction is whether the co-ownership arrangement between the partner(s) and the partnership constitutes a partnership or other constructive business entity for tax purposes. The IRS has provided guidance on when an undivided fractional interest in rental real estate will not be considered an interest in a business entity, but this guidance does not apply to interests in mineral properties.<sup>69</sup> This issue also arises when the replacement property is a tenant-in-common interest (or similar arrangement, such as a beneficial interest in a non-business trust).<sup>70</sup>

It appears that the IRS intends to scrutinize drop and swap and similar transactions. The partnership income tax return (IRS Form 1065) for 2008 includes two new questions in Schedule B:

13. Check this box, if during the current or prior tax year, the partnership distributed any property received in a like-kind exchange or contributed such property to another entity (including a disregarded entity).

---

<sup>68</sup> See Rev. Rul. 77-337, 1977-2 C.B. 305 (liquidation of corporation followed “immediately” and pursuant to a prearranged plan by shareholder’s exchange of the property received in the liquidation for replacement property did not qualify for like-kind exchange treatment because the shareholder did not hold the relinquished property for investment or productive use in a trade or business). *Bolker*, discussed in the preceding footnote, distinguished Rev. Rul. 77-337 on the ground that the taxpayer in *Bolker* held the property for three months before closing the exchange.

<sup>69</sup> Rev. Proc. 2002-22, 2002-1 C.B. 733. See also Ltr. Rul. 200327003; Ltr. Rul. 200625009.

<sup>70</sup> For a discussion of the use of syndicated tenancies in common as replacement property, including difficulties in the proper identification of tenancies in common as replacement properties, see Terrance L. Cuff, *Selecting and Describing TICs as Replacement Property*, 34 Real Est. Tax’n 32 (4th Quarter, 2006).

14. At any time during the taxpayer year, did the partnership distribute to any partner a tenancy-in-common or other undivided interest in partnership property?

Question 13 implies that the IRS believes that a partnership's transfer of replacement property to its partners or to another entity may defeat the partnership's eligibility for like-kind exchange treatment because the partnership did not hold the replacement property for investment or use in a business.<sup>71</sup> Question 14 implies that the IRS intends to question drop and swap transactions because the distributee partner did not hold the undivided interest in partnership property for investment or use in a business (as discussed above).

### **Partnership Mixing Bowl**

As an alternative to a like-kind exchange, a taxpayer might consider a contribution of the relinquished property to a partnership. The exchange of the relinquished property for a partnership interest generally will not give rise to a taxable exchange regardless of the character of the relinquished property (i.e., whether it is a direct interest in oil and gas property or an indirect interest such as an interest in a partnership that holds the property), the fact that the relinquished property is exchanged for a partnership interest, or the character of any other property in the transferee partnership.<sup>72</sup> Gain is deferred so long as the property contributed is retained by the partnership and used in its activities, and so long as the seller does not receive actual or deemed cash distributions from the partnership. If cash distributions are received, unlike

---

<sup>71</sup> See Rev. Rul. 75-292, 1975-2 C.B.333 (post-exchange transfer of replacement property to taxpayer's wholly owned corporation defeated like-kind exchange treatment). *But see Magnuson v. Commissioner*, 753 F.2d 1490 (9th Cir. 1985) (post-exchange contribution to partnership in exchange for a general partner interest does not defeat like-kind exchange).

<sup>72</sup> I.R.C. § 721. An important exception is I.R.C. § 721(b) involving contributions to a partnership classified as an investment company under rules comparable to those in Treas. Reg. § 1.351-1(c) (generally, more than 80% of the partnership's assets, other than cash and non-convertible debt, consist of readily marketable stocks and securities held for investment, or interests in RICs or REITs).

the gain to the extent of boot rule applicable in the case of a like-kind exchange, a distribution of cash from a partnership is taxable as gain only to the extent the cash received exceeds basis.<sup>37</sup>

Example 6: A and B are equal partners in AB partnership. AB owns Whiteacre and Blackacre. C owns Grayacre. Each property has the same value. A would like to exchange her 50% interest in AB for Grayacre, and C is agreeable to exchanging Grayacre for A's 50% interest in AB partnership. A direct exchange will not satisfy the I.R.C. §1031 exchange rules. Therefore, C will contribute Grayacre to AB partnership which will become ABC. The profits, losses, and distributions of ABC will be as follows:

- Whiteacre and Blackacre: 5% to A, 50% to B and 45% to C; and
- Grayacre: 90% to A and 10% to C.

Management of Grayacre rests solely with A and management of Whiteacre and Blackacre rests with B and C. After seven years, Grayacre is distributed to A in complete liquidation of A's interest in ABC partnership.<sup>47</sup>

There is no precedent directly blessing this transaction, and it is subject to challenge on form over substance and partnership anti-abuse grounds, as well as various statutory grounds involving disguised sales.<sup>75</sup> In addition, complexities associated with reallocations of liabilities encumbering any of the properties and special allocations of partnership tax items required with respect to pre-contribution unrealized gain in the properties, can diminish the

---

<sup>73</sup> I.R.C. § 731(a)(1). But see 707(a)(2)(B) and Treas. Reg. § 1.707-4(b) regarding whether operating cash flow distributions may be treated as disguised consideration for the sale of property to the partnership.

<sup>74</sup> The seven year waiting period is intended to avoid the disguised sale rule in I.R.C. § 704(c)(1)(B). There can be no prearranged plan during the seven year period to distribute Grayacre to A.

<sup>75</sup> See generally, Martin D. Ginsberg and Jack S. Levin, *Mergers, Acquisitions, and Buyouts* ¶ 1604 (Jan. 2009).

benefits of the transaction. Accordingly, only the well advised and courageous should consider such a transaction.

### **Leveraged Partnership**

It would be a rare case in which two parties would enter a transaction owning assets that they desire to exchange directly through the use of a classic mixing bowl partnership. More commonly, one party (seller) holds an asset (relinquished property) that it desires to sell to the other party (buyer) for cash that the seller will use to purchase new assets (replacement property) not owned by the buyer. As always, seller would like to avoid recognizing taxable gain on the sale of the relinquished property in order to maximize the cash proceeds that can be invested in the new property.

*Example 7:* L owns non-producing oil and gas property (“Blackacre”) having a value of \$100,000. L wants to sell Blackacre and reinvest the proceeds in non-like kind properties. D wants to purchase Blackacre for \$100,000 cash. D proposes that L contribute Blackacre to partnership P formed by D and L, to which D will contribute \$90,000 cash. L will receive (1) a Class A preferred partnership interest having a \$90,000 initial capital account balance and an 8% preferred return, and (2) 10% of the Class B common partnership interests having an initial capital account equal to \$10,000 and the right to receive a 10% share of residual profits (after payment of the preferred return). D will receive 90% of the Class B common partnership interest having a \$90,000 capital account balance and the right to receive a 90% share of residual profits. P loans L \$90,000. L uses the loan proceeds to acquire other assets.

*Example 8:* Same facts as Example 7. L contributes Blackacre to P for an initial 50% partnership interest, and D contributes \$100,000 cash to P for a 50% partnership interest. The cash will be used to purchase liquid but non-marketable assets designated by L. P obtains a \$90,000 loan from a third-party (or from a D affiliate) and distributes the loan proceeds to L in partial redemption of L’s interest in P. L guarantees the loan. L’s interest in P is reduced to

9.1% (\$10,000 capital account divided by \$110,000 total net capital).<sup>67</sup>

The latter form of this transaction has been addressed by the IRS in several technical advice rulings and the IRS has recommended attacking each of these transactions on a variety of grounds.<sup>77</sup> Despite the IRS's hostility to such transactions, a properly structured transaction having sufficient economic substance and business purpose may be successful in achieving the seller's objective of deferring or eliminating recognition of pre-contribution unrealized gain in the relinquished property.<sup>78</sup> On the other hand, the substance required to sustain a leveraged partnership's tax objectives is often at odds with the seller's interest in liquidating its interest in the relinquished property. Consequently, partnership mixing bowl transactions and leveraged partnership transactions are much more frequently discussed than they are actually implemented.

### Conclusion

This article has discussed the tax considerations relevant to various common transactions by which a developer might acquire mineral interests in specific

---

<sup>76</sup>This form of the transaction is premised on Treas. Reg. § 1.707-5(b)(1), which provides that if a partner transfers property to a partnership, and the partnership incurs a liability and all or a portion of the proceeds of that liability are distributed to the partner within 90 days of incurring the liability, the distribution is considered a disguised sale only to the extent the distribution exceeds that partner's allocable share of the partnership liability.

<sup>77</sup>Chief Counsel Adv. 200246014 (Aug. 8, 2002) (sham guarantee, disguised sale, anti-abuse regulations, form over substance, sham partnership); Tech. Adv. Mem. 200436011 (Apr. 30, 2004) (improper allocation of non-recourse liabilities); Chief Counsel Adv. 200513022 (Apr. 1, 2005) (improper debt allocation, anti-abuse, disguised sale).

<sup>78</sup>See Michael J. Kliegman and Jerome M. Schwartzman, *Puttin' on the Blitz: The IRS Attacks a Leveraged Partnership Transaction*, 44 Tax Mgm't Mem. 115 (Apr. 7, 2003) (agreeing with the conclusion in CCA 200246014 by suggesting more favorable facts could well justify a different conclusion); Robert Willens, *Newsday Postmortem*, 120 Tax Notes 1211 (Sep. 22, 2008) (discussing the Tribune Company's disposition of its Newsday subsidiary through a leveraged partnership with Cablevision Inc.).

properties. The next installment of this article will discuss certain tax considerations relevant to various transactions involving the acquisition of on-going oil and gas business.

*Information contained in the article is not intended to provide legal, tax, or other advice as to any specific matter or factual situation, and should not be relied upon without consultation with qualified professional advisors. Any tax advice contained in this document is not intended or written to be used, and cannot be used, for the purpose of (1) avoiding penalties that may be imposed*