Taxation of Oil & Gas Interests

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Agenda

• Overview: Capital vs. Ordinary
• General Definitions
• Taxation of Drilling and Production
• Sale of a mineral interest
• Sale of a business
  – Assets sale transaction
  – Deemed assets sale transaction
  – Equity/stock sale transaction
• Other transaction considerations
General Definitions

• Economic interest
  – Treas. Reg. §1.611-1(b)(1):
    “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 of legal
relationship, income derived from the extraction of the mineral
or severance of the timber, to which he must look for a return
of his capital.”

General Definitions

• Why is economic interest important?
  – Only the owner of an economic interest may deduct depletion or
  intangible drilling costs
  – Examples of an economic interest:
    • Net profits interest
    • Royalty interest
    • Carried interest
    • Working interest
    • Overriding royalty interest
General Definitions

- **Lease vs. sublease vs. sale**
  - A transaction will be classified as a lease if a grantor transfers all or a portion of the working interest to the grantee and reserves a nonoperating economic interest in the minerals that is expected to continue for the productive life of the property.
  - A sublease occurs when a lessee assigns the working interest and retains a nonoperating economic interest.
  - The transaction will be classified as a sale if no economic interest is retained by the transferor.

Overview: Capital vs. Ordinary

**Taxation of Oil and Gas Payments**

- **Oil and Gas Payments**
  - What item is the payment intended to substitute for?
  - What was the character of the underlying assets?

- **Transactions Taxed as Ordinary Income**
  - In absence of proof of the nature of the payments by the taxpayer, all payments are considered taxable as ordinary income.
  - Payor required to issue form 1099

- **Capital Transactions**
  - A taxpayer has the burden of proof to establish that the payments constitute a capital transaction or return of capital.
  - Payments are offset against the affected tax basis of the property. The affected area and allocated tax basis is question of fact.
## Overview: Capital vs. Ordinary

<table>
<thead>
<tr>
<th>Ordinary</th>
<th>Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>Section 1033 (involuntary conversion) not applicable to ordinary income property.</td>
<td>Section 1033 (involuntary conversion) could apply if property used in a trade or business.</td>
</tr>
<tr>
<td>Payments for rents and/or leases or rights of way are taxed as ordinary income. These agreements have the following features: Fixed time periods or reversionary interest to the owner.</td>
<td>A grant of perpetual easement is considered sale of interest in real property. Tax basis is the allocated portion of basis affected by the easement. Affected tax basis is a question of fact. Payor required to issue Form 1099 (interest in real property).</td>
</tr>
<tr>
<td>Payments for road easements for a fixed time period</td>
<td>Payments for actual damages or destruction of capital are applied against the affected portion of the asset damaged or destroyed. A taxpayer must prove the actual damages. Language in the settlement agreement is not controlling. Section 1231 could apply if used in a trade or business. Payor not required to issue Form 1099.</td>
</tr>
</tbody>
</table>

## Overview: Capital vs. Ordinary

<table>
<thead>
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<tr>
<td>Payments for shooting rights or seismograph testing</td>
<td>Payments for the diminution of the value of land is a capital transaction. Payor not required to issue Form 1099. The issue is the affected area and tax basis of the affected area.</td>
</tr>
<tr>
<td>Release for future or anticipated damages in absence of actual damages to capital</td>
<td>Payments for the destruction of goodwill can be a capital transaction. (Payor not required to issue Form 1099). However, at times there is a fine line between a destruction of goodwill and loss of profits, which would be ordinary income.</td>
</tr>
<tr>
<td>Payments for the destruction for growing crops. This substitutes for lost profits.</td>
<td></td>
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</table>
# Overview: Capital vs. Ordinary

## SUMMARY OF THE TAXATION OF OIL AND GAS PAYMENTS

<table>
<thead>
<tr>
<th>Type of Payment</th>
<th>How the Payment is Taxed</th>
<th>Payor Required to Issue FORM 1099?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Releases for future or anticipated damages</td>
<td>Payments for future or anticipated damages are considered ordinary income and a type of lease or rental income. The taxpayer has the burden to show the actual damages.</td>
<td>Yes</td>
</tr>
<tr>
<td>Easements and rights-of-way for a fixed time period</td>
<td>Payments are taxed as rental and/or lease ordinary income. The fixed time period causes the payments to be treated as a rental and/or lease type payment.</td>
<td>Yes</td>
</tr>
<tr>
<td>Road access easements for a fixed time period</td>
<td>Payments are taxed as rental and/or lease ordinary income.</td>
<td>Yes</td>
</tr>
<tr>
<td>Perpetual easements (No right of reversion back to the landowner)</td>
<td>Payments are considered received for the disposition of the easement which is considered a sale or exchange of an interest in real property. Payments are applied against the allocated tax basis of the granted easement area, with any excess treated as a capital transaction or Section 1231 gain if used in trade or business. Form 1099S required to be issued by the payor since this is considered a sale of an interest in real property.</td>
<td>Yes</td>
</tr>
<tr>
<td>Shooting rights or seismograph testing</td>
<td>Payments are considered rental type income unless actual damages are shown.</td>
<td>Yes</td>
</tr>
<tr>
<td>Payment for actual damages</td>
<td>The payments are applied against the affected tax basis of the property that was damaged. Gains could be Section 1231 gains if used in a trade or business.</td>
<td>Yes</td>
</tr>
<tr>
<td>Section 1033 nonrecognition treatment</td>
<td>Any realized gains can be deferred under Section 1033 if the payments were made under a &quot;threat&quot; of a condemnation. The statute does not require an actual condemnation in order for its relief provisions to apply, but merely a reasonable belief on the part of the taxpayer, taking into account all relevant facts at the time of sale, that condemnation is likely to occur.</td>
<td>Yes</td>
</tr>
</tbody>
</table>

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## Taxation of Drilling & Production
Drilling

- Deduction of Intangible Drilling Costs (“IDC’s”)
  - Although these are generally capital costs, the IRS allows these costs to be deducted in certain circumstances.
  - These costs are extremely high and the ability to deduct them now (as opposed to deferring them until the property produces) is extremely valuable.

- Treasury Regulation 1.612-4(a) provides that an individual is only allowed to elect to deduct intangible drilling and development costs if they hold a working interest or operating interest.
  - If the owner does not make the election to deduct intangible drilling and development costs, but instead charges them to a capital account, then those costs that are not represented by physical property may be deducted through depletion deductions. Treas. Reg. 1.612-4(b)(1).
- The costs that are represented by physical property and are capitalized are returnable through depreciation. Treas. Reg. 1.612-4(b)(2).
Drilling

- To deduct IDC's paid for in a taxable year, the well must be commenced, or “spudded” within 90 days after the taxable year in which the IDC deduction was claimed.
- Amounts paid on a prepaid turnkey drilling contract by 12/31 of year 1 will be deductible in year one if well or wells subject to the prepaid drilling contract are spudded by March 31 of the following year, unless year 2 is a leap year.
- In a leap year, wells must be spudded by March 30, but girls may ask boys out for a date on February 29, known as Sadie Hawkins Day.

Drilling

- IDC's, like depletion discussed below, is recaptured at ordinary income rates upon a disposition of the well.
- Recapture also applies to disposition of shares in an S corporation which has expensed IDC’s or claimed depletion or interests in a partnership which has expensed IDC’s or claimed depletion.
- Recapture also applies to dispositions of oil and gas properties in a qualifying like-kind exchange under Section 1031.
Percentage Depletion

• Percentage depletion or cost depletion.
  – Each year, owners must use the method that produces the larger deduction (except large companies or integrated oil companies with refining or retail sales must use cost depletion). Regs. § 1.611-1(a)(1).
• Percentage depletion - § 613.
  – Allows an owner to take a deduction of 15% of gross income from the property. § 613(b)(2).

Percentage Depletion

• Limitations:
  – Deduction cannot be taken if production is greater than 1,000 barrels per day. § 613A(c).
  – This limitation essentially forces large oil producing companies to use cost depletion.
  – Integrated oil companies with refining or retail sales are also precluded from using percentage depletion.
  – Deduction must be calculated for each separate property; therefore, an owner must maintain separate books for each property. §613.
Percentage Depletion

- Advantages:
  - Very simple to apply.
    - Deduction may be taken for as long as the property is owned and the deductions may exceed basis. Treas. Reg. 1.611-2(b)(2).

Cost Depletion

- Cost depletion - § 612.
  - Deduction based upon current production and the estimated life of production.
  - Deduction in the amount of current year’s production over total estimated lifetime production.
- Essentially the same as depreciation.
Cost Depletion

• Users.
  – Large companies who are required to use cost depletion (produce more than 1,000 barrels per day). § 613A(c) or integrated oil companies with refining or retail sales.
• Individuals for whom cost depletion produces a larger deduction than percentage depletion.
  – This method is also complicated because the deduction must be taken on each separate property; therefore, the individual must keep separate books for each separate property.

Cost Depletion

• Once this basis reaches zero or the deduction results in a deduction that is less than percentage depletion, cost depletion is no longer available to owners. Treas. Reg. 1.611-2(b)(2).
  – Because large companies (producing more than 1,000 barrels per day) or integrated oil companies with refining or retail sales are precluded from using percentage depletion, once the basis reaches zero, large or integrated companies cannot take a depletion deduction.
Self-Employment Tax

• Fee or lease owners, or co-owners, of a working interest in oil and gas properties are treated as carrying on a trade or business for self-employment tax purposes where the working interest is subject to a joint or other operating agreement that is not taxable as a corporation.
• Thus, where the activity under the operating agreement is treated as a joint venture (or partnership), or as a sole proprietorship (even though conducted by an agent of the sole proprietor), the working interest owner is conducting a trade or business for self-employment tax purposes.

Self-Employment Tax

• IRS held that income from overriding royalties is self-employment income where retained by taxpayers in connection with their operation of an oil and gas exploration and production company that constituted a trade or business. PLR 8427006
• In computing net earnings from self-employment, the distributive share of an item of income or loss of a limited partner (other than certain guaranteed payments, discussed below) is excluded. Thus, a taxpayer’s net earnings from self-employment couldn’t be reduced by a loss relating to the taxpayer’s investment in a limited partnership.
Sale of a Mineral Interest

• Lease bonus payments
  – Lessor’s tax consequences
    • Ordinary income as received. Treas. Reg. §1.612-3(a)(1).
    • If determined without regard to production, lease bonus is not
taken into account in computing the percentage depletion
allowance, but may be taken into account for purposes of cost
depletion. I.R.C. §613A(d)(5).
  – Lessee’s tax consequences
    • Part of the lessee’s depletable basis in the leasehold. Treas. Reg.
§1.612-3(a)(3). If production occurs, bonus is amortized over the life
of the property for purposes of computing percentage depletion
allowance. Treas. Reg. §1.613-2(c)(5)(ii). If the lessee does not drill
a producing well, or if the lease expires, unamortized bonus is
deducted as an abandonment loss. Treas. Reg. §1.165-1(a).
Sale of a Mineral Interest

• Lease bonus payments continued...
  – **Example.** Lessor owns a mineral interest with a basis of $10,000. Lessor executes a lease with Company and receives a $30,000 bonus and retains a 1/8 royalty.
  – Lessor has $30,000 of ordinary income in the year the bonus is received. Going forward, Lessor will have a $10,000 adjusted basis in the royalty, which will be reduced by future depletion deductions.
  – Company has a $30,000 adjusted basis in the property. If Company obtains production, that $30,000 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.

Sale of a Mineral Interest

• Lease bonus payments continued...
  – Traditional lease bonus is not tax efficient: lessee has immediate ordinary income, and lessor has a deferred deduction (if any)
  – Planning
    • **Increased royalty**
      – NB: substitutes contingent deferred payments for fixed up front payments
    • **Deferred bonus** – A cash basis lessor may be able to recognize income only as the bonus is received, unless the deferred payment obligation is transferable and readily saleable. *Kleberg v. Commissioner*, 43 B.T.A. 277 (1941); Rev. Rul. 68-606, 1968-2 C.B. 42.
Sale of a Mineral Interest

- Lease bonus payments continued...
  - **Minimum royalty.** 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. Treas. Reg. §1.612-3(b)(3).

Sale of a Mineral Interest

- Lease bonus payments continued...
  - Minimum royalty continued...
    - **Lessor tax consequences.** Ordinary income as received, though the payments will be received over a greater period of time. If the production royalty received 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. I.R.C. §613A(d)(5).
    - **Lessee tax consequences.** The lessee can elect to deduct minimum royalties in the year of payment. Treas. Reg. §1.612-3(b)(3). The deductions reduce the lessee’s gross income from the property for purposes of the lessee’s percentage depletion allowance. Treas. Reg. §1.613-2(c)(5)(iii).
Sale of a Mineral Interest

- Lease bonus payments continued...
  - Example of minimum royalty:
    - A grants B a five year oil and gas lease on a tract of land in return for a cash bonus of $10,000 and A reserves a 1/8 royalty. B 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. B 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.

Sale of a Mineral Interest

- Lease bonus payments continued...
  - Example of minimum royalty continued...
    - Lessor Tax Consequences
      - $10,000 ordinary income each year.
      - No percentage depletion deductions allowed.
    - Lessee Tax Consequences
      - Must capitalize the lease bonus and recover through depletion.
      - May deduct the minimum royalties as paid or accrued.
      - Lease bonus and minimum royalties reduce lessee’s percentage depletion allowance
Sale of a Mineral Interest

• Lease bonus payments continued...
  – 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; Wins v. 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.

Sale of a Mineral Interest

• Lease bonus payments continued...
  – Retained Production Payment
    • Traditional bonus and royalty arrangement is replaced with an upfront payment (bonus), a retained production payment, and a retained contingent royalty.
    • Lessor reports capital gain for bonus and all production payments (net of tax basis), except to the extent of imputed interest on production payments. Basis recovery but no percentage depletion.
    • Lessee capitalizes bonus and production payments as lease acquisition costs, and recovers the costs through depletion. Costs do not reduce lessee’s percentage depletion.
    • Result: less tax for lessor, depletion deduction for lessee
Sale of a Mineral Interest

• Sale or exchange
  – A transaction will be treated as a sale or exchange under three general circumstances:
    • the owner of any kind of interest assigns all of his interest without retaining any economic interest in the minerals;
    • the owner of any kind of interest assigns a fractional interest identical, except as to quantity, with the fractional interest retained; and
    • an owner of a working interest assigns any type of continuing nonoperating interest in the property and retains the working interest.

Examples:

– Retained royalty. Landowner A receives $10,000 from B for the right to explore for and produce minerals on A’s land. A reserves a 1/8 royalty interest or a net profits interest. This is a lease.

– Transfer of working interest. B transfers an undivided 75% working interest to C in exchange for $50,000 in cash not used in the development of the property. This is a sale.

– Transfer of override. B transfers an overriding royalty to C in exchange for $10,000. This is a sale.
Sale of a Mineral Interest

• Examples:
  – **Retained override.** B transfers an undivided 75% working interest to C in exchange for $50,000 in cash. B retains a 1% overriding royalty. **This is a sublease.**
    • B might be able to avoid sublease treatment by initially purchasing the overriding royalty interest from A in a separate entity, or by having a separate entity purchase the interest upon the transfer to B
    • B can avoid sublease treatment using a retained production payment and contingent royalty. See PLR 9437006.

Sale of a Mineral Interest

• **Sharing Arrangements**
  – A transaction in which a person (grantee) contributes cash, property, or services to the development of the property in exchange for receiving an economic interest in the property.
    • Differs from a sale or a lease in that the consideration given by the grantee is not received by the grantor; rather the grantee’s consideration is a contribution to the development of the property.
    – If the grantee receives an operating interest, the transaction is referred to as a “farmout”
Sale of a Mineral Interest

• Sharing Arrangements continued ...
  – Tax consequences: If the grantee’s contribution is used exclusively in the development of the property, the transaction is a nontaxable contribution to the costs of development under the “pool of capital doctrine.” *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.
  – Carved out production payments pledged for exploration or development can qualify as an economic interest. Treas. Reg. §1.636-3(a); Rev. Proc. 97-55, 1997-2 C.B. 582.
  – An interest received in exchange for services in locating or acquiring leases, or in supervising development, is not eligible for non-recognition. Rev. Rul. 83-46, 1983-1 C.B. 16. Landman must be in the chain of title to the lease to have an economic interest.

Sale of a Mineral Interest

• Carried Interests
  – A carried interest arises when one party (the “carrier”) agrees to pay development and operating costs for the share of the working interest owned by another (the “carried party”).
  – Generally, the carrier receives the carried party’s share of production until the carrier has recouped all development and operating expenses incurred on behalf of the carried party (including the operating cost incurred to produce such amount). The point at which the carrier recoups his costs is referred to as “payout.” Rev. Rul. 71-207, 1971-1 C.B. 160.
Sale of a Mineral Interest

• Carried Interests continued...
  – After the end of the complete payout period, the carrier and the
carried party allocate the income and expenses in accordance
with their respective shares of the working interest.
  – **Tax consequences:** If the carrier owns the entire operating
interest during the complete payout period, the carrier may
capitalize and depreciate all equipment costs and deduct all
IDCs. The carrier is also taxable on all income during the

Sale of a Mineral Interest

• Carried Interests continued...
  – **Fractional Interest Rule:** If the carrier is not entitled to
recoup all of its costs prior to reversion, then the carrier may
deduct only the fraction of costs attributable to its permanent
interest, and the fraction of the costs of equipment and IDCs
attributable to the operating interest held by the carried party
must be capitalized as leasehold costs. Treas. Reg. §1.612-
  – **Example 1:**
    • A agrees to pay all the costs of drilling and completing a well
on a property in exchange for 65% of the working interest. A
can elect to deduct only 65% of the IDC.
Sale of a Mineral Interest

• Carried Interests continued...
  – **Example 2:**
    • A agrees to pay all of the costs of drilling and completing a well on a property for 100% of the working interest until end of the complete payout period. B 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. A can deduct only 75% of the IDC, even if payout occurs within 3 years and even if B does not exercise its option.

Sale of a Mineral Interest

• Like-kind exchanges (§1031)
  – PLR 200807005
    • Taxpayer, a partnership, sold Relinquished Property through a qualified intermediary (QI) and 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 Taxpayer, and the general partner interests in P to an LLC wholly owned by Taxpayer.
    • Held: valid 1031 exchange.
      – QI and Taxpayer deemed to have acquired Replacement Property directly because P and LLC were disregarded entities.
    • Watch out for recapture under 1254 when replacement property not a mineral property.
Sale of a Mineral Interest

- Like-kind exchanges continued...
  - Partnerships can enter into tax deferred like-kind exchanges; Partnerships are viewed as separate entities when applying I.R.C. §1031.
  - Query—What if a partnership owned a piece of property and one partner wanted to exchange his/her interest in the partnership property for a property of like-kind? Can this be achieved?
    - Chase v. Commissioner, 92 T.C. 874 (1989)
    - Magneson v. Commissioner, 81 T.C. 767 (1977), aff’d, 753 F. 2d 1490 (9th Cir. 1985)

Sale of a Mineral Interest

- Like-kind exchanges continued...
  - Partnership Drop and Swap Transaction
    - Partnership holds a single piece of property as investment property. Partnership A has three equal partners, Jerry, Kramer and George. Jerry wishes to withdraw from the partnership and use the value in his interest to acquire a direct investment in like-kind property owned by Elaine.
    - Can Jerry have the partnership distribute an undivided 1/3 interest in Partnership A’s property to him tax-free, which he then exchanges tax-free under I.R.C. §1031 for Elaine’s property? This may be possible according to some commentators.
      - When Can Exchange of Interest in Real Estate Partnership for Direct Interest Be Tax Free, 60 J. Tax’n 152 (March 1984).
      - Does this qualify under the “held” doctrine for purposes of I.R.C. §1031?
Sale of a Mineral Interest

- Like-kind exchanges continued...
  - Partnership mixing bowl
    - A and B are equal partners in AB partnership. AB owns Whiteacre and Blackacre. C owns Greyacre. A would like to exchange her interest in AB for Greyacre, but realizes a direct exchange will not satisfy the I.R.C. §1031 exchange rules. As a result, the parties agree that C will contribute Greyacre to AB partnership which will become ABC. The profits, losses, and distributions of ABC will be as follows: (1) Whiteacre and Blackacre, 5% to A, 50% to B and 45% to C and (2) Greyacre, 90% to A and 10% to C. Management of Greyacre rests solely with A and management of Whiteacre and Blackacre rests with B and C.

Assets Sale Transaction

- Issue 1: withholding taxes
  - Real Estate: get certificate of Seller’s non-foreign status
  - State taxes: get tax clearance certificates
    - Timing of getting no tax due certificates may create problems and/or exposure to Buyer
Assets Sale Transaction

• Issue 2: Texas franchise tax
  – Location of the payor rule
    • If Buyer is a Texas entity, Seller sources gain on sale of intangible assets to Texas; increases portion of Seller’s income (including gain on sale) that is subject to Texas franchise tax
    • If Buyer is a non-Texas Buyer entity, Seller sources gain on sale of intangible assets outside Texas, thereby favorably diluting Seller’s Texas apportionment factor for year of sale

Franchise tax illustration

– Facts
  • Margin from operations = $100
  • Gain on sale = $200, all from sale of goodwill
  • 100% of operating income is from Texas sources
– If Buyer is a Texas entity, taxable margin = $300
– If Buyer is a Delaware entity, taxable margin = $100
  • $300 total margin x $100 TX receipts ÷ $300 total receipts
Assets Sale Transaction

- **Issue 3:** Texas franchise tax (con’t)
  - If assets are held by an LLC, consider a conversion by merger to a partnership shortly before the sale so that the selling entity might qualify as a passive entity for the accounting period that includes the sale
  - Consider distribution of the installment note and buyer equity to avoid recognition of income in a taxable entity

Assets Sale Transaction

- **Issue 4:** the year end deal
  - Buyers and Sellers are often motivated to try to close transactions by year end for emotional reasons
  - The Seller is often highly advantaged by closing on January 1 of year 2 versus December 31 of year 1
    - Full year depreciation for year 1
    - Up to one year deferral of payment of tax on sale
    - Special considerations may apply if the transaction is effectively closed in year 1 with only receipt of payment delayed until year 2
  - Delayed closing inadvisable if tax rates will increase
Assets Sale Transaction

- Issue 5: assumed contingent liabilities*
  - Payment = purchase price, not a deduction
    • Seller treats as sale proceeds and imputed deduction
    • Buyer capitalizes purchase price when paid or incurred
    • See Illinois Tool Works, Inc. v. Commissioner, 355 F.3d 997 (7th Cir. 2004)
      - Note: under new GAAP rules, payment in excess of fair value estimate = Buyer expense
      - Buyer should try to separate post-acquisition accruals, including imputed interest

*More likely to arise in a deemed assets sale transaction

Assets Sale Transaction

- Issue 6: pre-closing income allocation
  - If Buyer is allocated cash flow from signing to closing, who is taxed on the related income?
    - Answer: Seller
      • See PLR 8718003
Other Transaction Considerations

- Using a tax-exempt as a financing party
  - Unrelated business taxable income ("UBTI") – I.R.C. §512(a) provides that exempt organizations are taxed on UBTI. Generally speaking, UBTI is income from any unrelated trade or business regularly carried on and which is not substantially related to the performance by the organization of its exempt purposes.
  - Exemption for Royalties, Overriding Royalties, and Lease Bonus Payments from UBTI. I.R.C. §512(b)(2) provides that “there shall be excluded all royalties (including overriding royalties) whether measured by production or by gross or taxable income from the property, and all deductions directly connected with such income.”
Other Transaction Considerations

• Using a tax-exempt as a financing party
  – **Net Profits Interests.** Neither the Code nor the regulations state whether a net profits interest is a royalty and therefore exempt from the UBTI taint. This issue was addressed in *Welch Foundation v. United States.* The court ruled that a net profits interest constitutes a royalty for purposes of I.R.C. §512(b) and therefore exempt from the UBTI taint. *Welch Foundation v. United States,* 334 F.2d 774 (5th Cir. 1968). *See also* Rev. Rul. 73-541, 1973-2 C.B. 206; PLR 7741004; PLR 8226160; PLR 8839016; PLR 8848066.

Other Transaction Considerations

• Using a tax-exempt as a financing party
  – **Income from Working Interest is UBTI.** The income derived from a working interest is considered UBTI and therefore subject to federal income tax. Treas. Reg. §1.512(b)-1(b). *See also* Rev. Rul. 69-179, 1969-1 C.B. 158 (stating that an exempt entity cannot exempt working interest income from UBTI by contractually shifting development costs, but not operating costs, to an independent operator).
Other Transaction Considerations

- Using a tax-exempt as a financing party
  - Blocker structure below
  - Could also use a NPI

Other Transaction Considerations

- Section 1245 depreciation recapture
- Example
  - Assume a taxpayer purchased oil and gas depreciable equipment for $500 and has depreciated such equipment in a total amount of $100. The remaining tax basis in the equipment is $400. If the taxpayer sells the equipment for $500 the taxpayer would have a $100 gain ($500 - $400) all of which would be ordinary income pursuant to I.R.C. §1245.
Other Transaction Considerations

- Depreciation recapture in a partnership
  - Treas. Reg. §1.1245-1(e)(2)
  - Example – potential trap for the unwary
  - A, B, and C form general partnership ABC. The partnership agreement provides that depreciation deductions will be allocated equally among the partners, but that gain from the sale of depreciable property will be allocated 75% to A and 25% to B. ABC buys depreciable personal property for $300 and subsequently allocates $100 of depreciation deductions each to A, B, and C, reducing the adjusted tax basis of the property to $0. ABC then sells the property for $440. ABC allocates $330 of the gain to A (75% of $440) and $110 of the gain to B (25% of $440). No gain is allocated to C.

Other Transaction Considerations

- IDC recapture issues
- Depletion recapture issues
- Recapture issues with partnerships
  - General Rule
  - Exceptions to partner level recapture
  - Example 1 – partner level recapture
  - Example 2 – special allocation of intangible drilling and development costs
  - Example 3 – I.R.C. §59(e) election to capitalize intangible drilling and development costs
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