**Geological & Geophysical (G&G) Costs**

**Burnet v. Harmel**: federal tax consequences can NOT be changed by state law

**Concept**: O&G production starts with shooting seismic to see if there’s O&G

**G&G Costs**: Costs associated with shooting seismic, such as:

 **1) Actual Labor costs** 3) Cost to **analyze data** from shooting

 **2) Equipment/supplies** costs of shooting

**Old Law**: Capitalize G&G costs into the lease

**Current Law**: **IRC 167(h)**: distinguishes between foreign and domestic G&G

***Domestic G&G***

 **Most TPs**: **IRC 167(h)(1) Recovery Period**: **24 Month Amortization**

 **Convention**: **Half Year Convention**

 **Major Integ. Comp**: **IRC 167(h)(5) Recovery Period**: **7 Year Amortization**

 **Convention**: **Half Year Convention**

 **Definition**: O&G producer with average daily production over 500,000

barrels/day and $1B in gross receipts (Exxon, Shell, BP, Chevron)

 **Lessor’s POV**: **Shooting Rights Agreement**: if lessee paid lessor for the right to

 shoot seismic, it is ordinary income to lessor

 **Exclusive Method**: **IRC 167(h)(3)**: this is the **ONLY way to deduct G&G costs**

 **CGG American**: It does NOT matter what business TP is in, no TP gets an

 immediate deduction, ever

 **Ex**: TP does seismic shooting and sold data to others

 **Court**: It does NOT matter if TP is a lessee, producer, or hired for

seismic, if it is a domestic G&G cost, then 24 month amortization

 **Abandonment/Resale**: **IRC 167(h)(4)**: even if TP sells/abandons the property,

 TP must continue amortizing over the 24 month period

***Other Issues***

***Option Payments***

**Option Payments**: Shooting rights agreement with the option to lease in the future

 **Lessor POV**: Ordinary income

 **Lessee POV**: Capitalized into the lease

 **Abandonment**: CAN deduct for abandonment if doesn't exercise the option

***Dry Hole & Bottom Hole Contribution Agreements***

**Dry Hole Contribution K**: A will pay money if a well is dry in exchange for G&G data

**Bottom Hole Contrib. K**: A will pay money if well is drilled to X depth for G&G data

 **Domestic**: Treat as G&G Cost

 **Foreign: Revenue Ruling 80-153**

 **Payee POV**: reports income

 **Payor POV**: capitalizes the cost into the lease

 **No Deduction**: If payor drills dry hole, payor can NOT immediately deduct

**Ex**: A pays $7,200 for shooting rights agreement with Texas on 3,600 acre tract. A pays $36,000 for preliminary survey. A identifies three areas. Area 1: 100 acres, $5,000 on detailed survey, abandoned. Area 2: 600 acres, $20,000 on detailed survey, leases Part A (50 acres) and Part B (150 acres). Pays $10,000 bonus. Area 3: 400 acres, $12,000 on detailed survey, no lease yet. What would the result be if A was NOT major integrated O&G company? Was a major integrated O&G company?

 Shooting K Prel. Surv. Det. Surv. Total

Area 1 $2,400 + $12,000 + $5,000 = $19,400

Area 2 $2,400 + $12,000 + $20,000 = $34,400

Area 3 $2,400 + $12,000 + $12,000 = $26,400

**Area 1**: NOT Major Integrated YES Major Integrated

 $19,400 $19,400

 ———— = $808.33 ———— = $230.95

 24 Months 84 Months

 Y1: $4,850 ($808.33 x 6 months) Y1: $1,386 ($230.95 x 6 months)

 Y2: $9,700 ($808.33 x 12 months) Y2-Y7: $2,771 ($230.95 x 12 months)

 Y3: $4,850 ($808.33 x 6 months) Y8: $1,386 ($230.95 x 6 months)

**Area 2**: NOT Major Integrated YES Major Integrated

 $34,400 $34,400

 ———— = $1,433.33 ———— = $409.52

 24 Months 84 Months

 Y1: $8,600 ($1,433 x 6 months) Y1: $2,457 ($409 x 6 months)

 Y2: $17,200 ($1,433 x 12 months) Y2-Y7: $4,914 ($409 x 12 months)

 Y3: $8,600 ($1,433 x 6 months) Y8: $2,457 ($409 x 6 months)

**Area 3**: NOT Major Integrated YES Major Integrated

 $26,400 $26,400

 ———— = $1,100 ———— = $314.29

 24 Months 84 Months

 Y1: $6,600 ($1,100 x 6 months) Y1: $1,885 ($314 x 6 months)

 Y2: $13,200 ($1,100 x 12 months) Y2-Y7: $3,771 ($314 x 12 months)

 Y3: $6,600 ($1,100 x 6 months) Y8: $1,885 ($314 x 6 months)

***Foreign G&G***

**Revenue Ruling 83-105**: Old law still applies to foreign G&G costs (see below)

 **Effect**: TP must keep supporting docs of analysis and records

**General Rules**: ***1) If Has/Acquires A Lease***

Capitalize G&G costs into lease

 ***2) Shooting Rights Agreements***

Spread G&Gs equally over the area of interest, no

 matter who many acres are in each area

 **Ex**: 100 acres. If $10 G&G costs and 5 areas, $2 to

 each area even if D only has 3 acres

 ***3) If No Lease Yet & Abandons After Shooting***

Immediately deduct the costs for the abandoned area

 ***4) If No Lease Yet But Has NOT Yet Abandoned***

 Suspend G&G costs until TP gets a lease

  **A) Federal Land**: **Revenue Ruling 83-105**: If no lease/

 abandonment after **10 years**, deduct suspended cost

  **B) Private Land**: **Revenue Ruling 83-105**: If no lease/

 abandonment after **5 years**, deduct suspended cost

 ***5) Partial Abandonment***

 **Bonus**: Lessee can NOT deduct the bonus lessee paid

 **Other Costs**: Lessee CAN immediately deduct the costs

for that area (or depth) that lessee is abandoning

 ***6) Leases Separate Parts of the Same Area***

 Allocate based on acreage in each part

 **Formula**: Area 1’s Acres

 —————— x G&G Costs

 Total Acres

 **Revenue Ruling 77-189**: ***1) Reconnaissance Survey***: Allocate equally

 Broadly looks at an area

 ***2) Detailed Survey***: Allocate to specific area

 After reconnaissance, does a more detailed

 survey on certain parts

 ***3) Lease Decisions***: lessee gets a Shooting Rights K

**Ex**: A pays $7,200 for shooting rights agreement with Burma on 3,600 acre tract. A pays $36,000 for preliminary survey. A identifies three areas. Area 1: 100 acres, $5,000 on detailed survey, abandoned. Area 2: 600 acres, $20,000 on detailed survey, leases Part A (50 acres) and Part B (150 acres). Pays $10,000 bonus. Area 3: 400 acres, $12,000 on detailed survey, no lease yet.

 Shooting K Prel. Surv. Det. Surv. Total Treatment

Area 1 $2,400 + $12,000 + $5,000 = $19,400 Deductible

Area 2 $2,400 + $12,000 + $20,000 = $44,400 Capitalized

Area 3 $2,400 + $12,000 + $12,000 = $26,400 Suspended for 5 years

**Area 2**: **Part A**: 50 acres **Part B**: 150 acres

 $34,400 x ———— = $8,600 Allocated $34,400 ————— = $25,800 to

 200 acres to Part A 200 acres Part B

**Ex**: Same facts, but, later, A decides to abandon Part A. But, Bc A wants to keep trying to reduce on Part B, A retains the lease

 **Bonus**: Can NOT deduct the $10,000 bonus

 **Part A G&G Costs**: CAN deduct the $8,600 allocated to Part A

**Ex**: Same, but A find O&G at 3,500-4,000 depth on Part B. Does detailed survey on 4,000+ depth ($10,000) & finds no O&G. A abandons formations under 4,000 feet

 **Part B G&G Costs**: CAN deduct $10,000 spent on the detailed survey

**Economic Interest (EI)**

**Concept**: Used to divide up income and depletion

 TP ONLY has an EI if TP stands to gain/lose if O&G is/is not produced

**Elements**: **RR 1.611-1(b)(1)**: **Yes economic interest if:**

***1) TP Has Acquired By Investment***

 **Concept**: there was a lease bonus (if required) and a commitment to develop

***2) Any Interest in Minerals In Place***

 **Concept**: **Legal ownership** —> NOT an EI if merely a buyer/refiner of O&G

 **Palmer v. Bender**: “Ownership” for tax NOT the same thing as state legal title

 Multiple people (lessor, lessee, sublessee, NPI holder, or production

 payment holders) can have an EI bc EI flows down the chain

 If O&G is started/stopped, does TP get paid/not paid?

 **Ex**: After lessee (A) discovers O&G, A transfers land interest to B for $50

 bonus, retaining 1/8 royalty, production payment of $250

 **Effect**: Yes lease under **Palmer**, A looks solely to minerals for return of

 his capital (royalty and PP), meaning B holds an EI

 **Southwestern Exploration**: Literal legal ownership of the surface over which

 the minerals are is NOT required to have an EI if surface owner gets paid

 from production (offshore rig and CA state law)

 **Estate of Donnell**: TP has no EI in **“illegally captured”** O&G

 If TP trespasses and drills a well, no EI in O&G produced

 **Gulf Oil Corporation** **– Iranian Oil**: yes EI even if foreign nation bans TP from

 holding legal title to the minerals (has all the up/downside risk)

 Can have an EI even if there’s a specific sovereign ban on US ownership

***3) And Secures, By Any Type of Legal Relationship, Income from O&G Production***

 **Concept**: TP looks to O&G for income

 **Royalties**: Yes economic interest

 **Production** **Payments**: Yes economic interest

 Payor & payee BOTH have EI bc O&G production is used to satisfy the PP

 **Thomas v. Perkins**: Assignor & sublessee DO have an EV **if they retain a PP**

 **NPI**: **Kirby Petroleum**: Yes economic interest if TP holds NPI and a royalty

 **Burton-Sutton**: Yes economic interest if TP holds NPI, even if no royalty

***4) And, TP Must Look [*Solely *to Production] For a Return on TP’s Capital***

 **Economic Advantage**: **Helvering v. Bankline Oil**: there’s difference between

 economic advantage (not an EI) and economic interest

 If TP can look to another stream of income (refining), NOT an EI

 Mere economic advantage of owning a refinery near O&G is NOT an EI

 **O’Donnell v. Helvering**: Merely being a SH in a Corp that has O&G leases is

 NOT an EI bc TP can look to other Corp activities for ROI/return on capital

 Even if production stops, TP can still earn income in some way

 **Ex**: A owns a plant. A enters long-term K with B. A will process O&G in

 exchange for keeping 1/3 of the O&G extracted

 Under **Helvering v. Bankline Oil**, a plant owner can NOT have an EI in

 leases when A’s income generated is from plant processing

 A has no control over productions decisions of the O&G and no

 recourse if the lease ends (mere economic advantage)

 **Alternate Source** **of Income**: **All or Nothing Test** – TP MUST look **“solely”** to

 production for income (NOT EI if TP can look to other sources to pay lessor)

 ***A) Horizontal Alternate Source of Income***: **NOT an EI**

 **Concept**: TP is not part of the entire investment

 **Ex**: NOT an EI if TP ONLY runs a refinery

 **Ex**: NOT an EI if TP can force another to sell land to make get paid

 **Anderson v. Helvering**: NOT EI bc TP could look to BOTH production

 payments or to the sale of land on the lease to get paid

 **Ex**: Lessee (A) enters K with B to sell royalties, land, & deferred O&G

 payments for Land. A will get $100. $50 is from cash, $50 is from 1/2

 of proceeds (can come from O&G production and/or sale of Land)

 Effect: B does NOT have EI bc B has Horizontal alternative source

 of income (sale of fee lands can satisfy the “production payment”)

 ***B) Vertical Alternate Source of Income***: **Yes an EI**

 **Concept**: TP is part of the entire investment

 **Caution**: No EI in downstream income so no depletion for it

 **Weinert’s Estate**: Yes an EI bc TP financed both the drilling AND

 refining, and can pay lessor from either activity’s profits

 **Ex**: Lessee (A) enters K with B for a carried interest to develop O&G

 & build gas plant (integral to ops). B will carry costs for 1/2 interests

 in O&G property & gas plant. Gas plant has a small fractionation unit

 B DOES have EI under **Weinert** assuming only that a small amount

 of income is anticipated from the fraction process in the gas plant

 **Effect**: B gets depletion from upstream production revenues,

 but NOT on the “downstream” fractionation revenues

 **Savings Clauses**: **IRS Technical Advice Memo 99-18-002**: Savings clauses can

 preserve an economic interest

 **Concept**: “NPI of X% to TP, limited to gross production from the well

 **Effect**: If TP later transfers TP’s NPI to another, transferee still has an EI

**Examples**

 **Ex**: Lessee (A) entered O&G lease, giving Net Profits Royalty payments to

 landowner (B) calculated on the value of LNG on export, but is limited to no

 no more than gross production from the property as defined in IRC 613(c)

 Under **IRS Technical Advice Memo 99-18-002**, this is a savings clause that

 ensures A (landowner/lessor) will not be made more than the gross

 income from the property

 Effect: B holds an EI and can deplete his royalty payments

 **Ex**: A gets a permit to develop offshore, but is required to drill on land. A

 enters agreement with landowner (B) to drill from B’s onshore property. B

 gets a 50% NPI so that A can drill

 B can deplete income from NPI under **Southwest Exploration** bc B only

 looks to the minerals in place from onshore land that was essential to ops

**O&G Leasing Transaction**

***Bonuses***

**Lessor POV**: **Burnet**: **Ordinary, depletable income** (benefits multiple periods)

 **See Also GCM 22730**: a lease divides O&G in place between lessor & lessee…but

 lessor is NOT treated as having disposed a capital asset

**Lessee POV**: **Fitzsimons**: **Capitalized, depletable cost**

**Advanced Royalties**: treat like a bonus

**Ex**: Lessee pays lessor $10,000 bonus for a lease. Primary term of 5 years, 1/8 royalty, delay rental of $5/acre (4,000 acres) every year. Tax at lease?

 **Bonus**: **Lessor’s POV**: Ordinary, depletable income

 **Lessee’s POV**: Capitalized into his lease

***Delay Rentals***

**Lessor POV**: **Sneed**: **Ordinary,** **non-depletable income**

**Lessee POV**: **Capitalized, depletable cost**

**Differentiate from Bonus**: **Revenue Ruling 80-49**: If payment is a year-to-year obligation to keep the lease, it is a delay rental

 **RR 1.612-3(c)(1)**: delay rental if paid to permit the deferral of development

 **Factors**: If payment is due regardless of production, what recourse lessor has

***Royalties***

**Lessor POV**: **Ordinary, depletable income**

**Lessee POV**: **Twin Bell**: **Excluded** from lessee’s gross income

**Overriding Royalties**: Same treatment

 Carved out of lessee’s interest, lasts as long as the lease that created it lasts

**Ex**: 1/8 royalty to lessor. Lessee produces $24,000 in O&G

 **Lessor POV**: Includes $3,000 in income

 **Lessee POV**: Includes $21,000 in income

***Shut-In Royalties***

**Lessor POV**: **Johnson v. Phinney**: **Ordinary**, **non-depletable income**

 **Johnson v. Phinney**: Discussion/comparison of shut-in v. min royalties and court

 decided that they were more like delay rentals

**Lessee POV**: **Capitalized, depletable cost** (same as a delay rental)

 **PROF**: less certain bc, prior to IRC 263A, lessee could’ve deducted

 **PROF**: IRS would likely argue for capitalization (like delay rentals)

***Minimum Royalties***

**Concept**: Paid even if no production, “lessee must pay $X before production”

**Recoupable**: Lessee reduces future royalties by Advanced royalties already paid

**Non-Recoupable**: can NOT reduce future royalties by the advanced royalties paid

**Lessor POV**: **1) General Rule**: Ordinary, depletable income up to gross production

 **2) Recoupable**: Amounts paid in excess of gross production are

 **ordinary, depletable income**

 **3) Non-Recoupable**: Amounts paid in excess of gross production are:

 **A) If Lease Ends for Non-Payment**: **Ordinary,** **non-depletable**

 **B) If Lease Does NOT End If Non-Payment**: **ordinary, depletable**

**Lessee POV**: **1) Recoupable**: A) If must pay despite production/abandonment:

 **Capitalized, depletable cost** (like a bonus)

 B) If need not pay bc of production/abandonment:

 **Capitalized, depletable cost** (like delay rental)

 **2) Non-Recoupable**: Capitalized, depletable (like a bonus)

 **3) Election**: **RR 1.612-3(b)(3)**: lessee can elect to deduct advanced

 royalties in the year lessee paid them

 **Revenue Ruling 80-70**: If lessee enters a lease on November

 30th, then lessee can ONLY deduct 2/12 of the advanced

 royalties paid in that year

***Production Payments***

**Concept**: **RR 1.636-3(a)(1)**: Not expected to last entire lease, specific amount up to $X, found with R accuracy at creation (can be 1 for multiple non-contiguous lands)

 **Watnick**: If a “production payment” will last the entire lease, it’s really a royalty

 If there’s no R forecast of payment, it is NOT a production payment

 **Revenue Ruling 95-55**: **Safe Harbor** for determining if it’s a production payment

 Yes a PP if it is Rly expected: 1) To end on production of 90% of the reserves;

 2) PV of production expected to remain after

 termination is 5% of PV of the entire property

 3) And, limited by a specific dollar, time period,

 or quantity of mineral

**Lessor POV**: **Ordinary, depletable** **income**

**Lessee POV**: **IRC 636(c)**: **Capitalized, depletable** **cost** each year as paid

 Treat as an “installment bonus” in year that lessee pays the additional “bonus”

 **Old Law**: Pre-**IRC 636**, lessee would exclude production payment from income

**Analysis**: 1) Is it a production payment or a royalty? (see below)

**Take or Pay Agreements**: must pay $X regardless of if there’s production

 **Freede**: Take or Pay Agreements are NOT PPs and are NOT treated as loans

 **Lessor POV**: Ordinary, non-depletable income to lessor

***Net Profits Interests***

**Concept**: Pays X% of profits until $X is paid (payout)

**Differentiate from Royalties**: **Royalties**: do NOT bear the costs of production

 **NPI**: DO bear the costs of production

**Lessor POV**: **Ordinary, depletable income** (like a royalty)

**Lessee POV**: **Excluded from lessee’s gross income** (like a royalty)

**Ex**: Lessor has 1/3 NPI. Lessee drills well costing $50,000 and has $15,000 other production costs. Lessee produces $75,000 of O&G

 **Lessor POV**: $3,333.33 of ordinary, depletable income

 **Lessee** **POV**: $71,667.33 depletable income

**O&G Financing Arrangements**

Lessee enters to shift risks to others in exchange for a share of future production

**Types**: **1) Pool of Capital Doctrine**: pooling resources to conduct E&P

 **2) Farm-Ins**: involves a new party who does not (yet) have an EI

 **3) Carried Interests**: Both parties have EIs, but B doesn't spend money

 **4) Production Payments**: Lessee gives X% of production to B up to $X

 in exchange for cash

***Pool of Capital Doctrine***

***Generally***

**Concept**: Contributing services/property in exchange for an EI in future production

**General Rule**: If qualifies, **non-recognition** of income when driller/supplier give services/materials in exchange for an EI in the well

**Issue**: **IRC 83**: If TP performs services in exchange for property, include the FMV of the property received in TP’s income

**Solution**: **IRC 636(a)**: “Production Payments” that are pledged or used for E&P or development are NOT included in TP’s income

 **Effect**: Contributor of services is NOT viewed as performing services for comp,

 but rather treated as having got a capital interest in an ongoing pool of capital

 **Palmer v. Bender**: Pool of capital is a **non-recognition** event

 Pooling interests and capital while only looking to production for an ROI

 **Elements**: 1) TP contributes services in exchange for an EI/share of production;

 2) The services contributed are NOT a substitute for capital;

 3) The services were necessary to bring about O&G production; and

 4) Contribution must be **specific to the property** that CP got an EI in

 **Revenue Ruling 77-176**: performance of service in exchange

for EI in drill-site acreage DOES qualify for pool of capital

 **Outside Acreage**: services in exchange for EI in non-drill

 site land does NOT qualify for pool of capital

 **Specific to Property**: EI acquired must be for the same

 property that the materials/services were rendered

 **Ex**: Lessee (A) assigns 50% of his working interest in the drill site to Driller (B). A

 also assigns 1/16 ORIH in “remaining acreage” (outside acreage)

 **50% Working Interest**: Non-recognition under pool of capital

 **Effect**: B does NOT recognize income for the 50% working interest

 B can deduct 50% of drilling costs

 **1/16 ORIH**: Does NOT get non-recognition under Revenue Ruling 77-176

 **Effect**: B recognizes income equal to FMV of ORIH on date of assignment

 B must capitalize 50% of drilling costs

 **Ex**: Lessee (A) hires B (geologist) to do G&G tests on the lease for $5,000

 **A’s** **POV**: A must capitalize $5,000 G&G payment (see above)

 **B’s POV**: B recognizes $5,000 of income (didn’t get an EI in exchange)

 **Ex**: Lessee (A) hires B (geologist) to do G&G tests on the lease for 1/16 ORIH

 **A’s POV**: A must capitalize $5,000 G&G payment (see above)

 **B’s** **POV**: B gets non-recognition of income pool of capital treatment

***Limits***

**James A Lewis Engineering**: POC doctrine does NOT apply to 2ndary recovery ops

 **Revenue Ruling 83-46**: Pool of capital is limited to more direct services to E&P

 Legal/accounting/engineering work do NOT get POC treatment (attenuated)

 **Ex**: A (lessee) gives B (lawyer) 1/16 ORIH in exchange for legal work on the lease

 **B’s POV**: B immediately recognizes income equal to FMV of ORIH

**GCM 22730**: Costs incurred by the driller/supplier in exchange for an EI in an O&G well is NOT a taxable event but rather a capital expenditure

 **Effect**: No income realized, no tax due, treat PPs for E&P as non-recognition

 **Chart**: **Ordinary, Depletable** **Mortgage**

 **Income** <———PP——— **Loan**

 **AR** <———Cash——**Capitalized**

A——Lease——> B ——Assigns Lease——> C ——Farm-Out———> D

**Ordinary** <—Royalty— **Excluded** <— Full Carry————

**Depletable** <—Bonus— **Capitalized** <—NPI Post-Payout—

**Income** <—PP—— **Capitalized**

 **Exclusion** **Ordinary, Depletable**

 ———PP—————> **Income**

 \_\_Well-Farmout \_\_\_\_\_E

 |

 |

 D —|

 |

 |\_\_Well-Farmout \_\_\_\_\_F

 ———PP—————> **Ordinary,** **Depletable**

 **Exclusion** **Income**

 **Ex**: Lessee (A) conveys 100% working interest to driller (B) on the entire

 lease. Once B recoups costs, 50% of working interest reverts to A

 **A’s POV**: not taxed on the reversion under POC

 **B’s POV**: B gets full deductions during payout

***Carried Interests***

**Concept**: When one co-owner agrees to develop on another co-owners behalf in exchange for an additional interest

**Drilling/Depreciation Deductions**: **Husky**: the party that carries the burden of development gets the deductions, even if they aren’t legally obligated to drill

**Limited Carry**: **Carrying party (A)** gets 100% of lessee’s interest (**carried party (B)**) for X period and/or until A recoups all of his costs from production

 **Effect**: B has no interest until payout

**Unlimited Carry**: A gets the right to all production until he recoups his costs

 **Effect**: B only shares in production if the well is profitable (i.e. only if NPI)

**Types**: **1)** **Cocke** **Carried Interest**

 **Ex**: A owns 50%, BC own 25% each, A can recoup costs from BC

 **Carrying Party**: A gets all deductions until payout

 **Carried Party**: BC do NOT get income/deductions until payout

 **Ex**: Lessee (B) let Driller (A) drill, but B got 1/16 of ops profits after

 A recoups all costs. In Y1, A paid $0 to B bc cost exceeded income.

 Does A (carrying party) have to report income on a 100% basis

 until costs are recouped? Or can A exclude 1/16 from income?

 **Post-Cocke**: A reports 100% of income

 **Pre-Cocke**: under **Abercrombie**, A excludes 1/16 from income

 **Ex**: Same facts. Can B deduct 100% of the IDC costs until payout?

 **Post-Cocke**: A gets 100% of the deductions

 **Pre-Cocke**: under **Abercrombie**, A gets 15/16 of deductions

 **2)** **Manahan** **Carried Interest** (Reversion to B after payout)

 **Ex**: AB own 50%. A gets 100% of income until payout, then 50%

 **Carrying** **Party**: A gets all deductions until payout

 **Carried** **Party**: does NOT get income/deductions until payout

 **Ex**: B (lessee) assigns 100% of working into to driller (A). After A

 recovers all costs, 50% of working interest reverts to B. In Y1, A

 incurs $10 of IDC & has $3 of deprec. deductions on equipment

 **At Creation**: non-recognition event

 **At End of Y1**: **A’s POV**: A reports 100% of gross income

 A gets 100% of deductions

 **B’s POV**: no gross income, no deductions

 **At Reversion**: non-recognition event

 **3)** **Herndon** **Carried Interest**

 **Concept**: A gets production payments until payout

 **Carried** **Party**: does NOT get income/deductions until payout

 **4)** **Abercrombie** **Carried Interest**

 **Concept**: A keeps a small interest of X% of operating profits

 **Carried** **Party**: does NOT get income/deductions until payout

***Payout Periods***

How to allocate deductions before there is full payout?

 ***Complete Payout***: **Revenue Ruling 69-332**: A gets all deductions if 100% payout

 ***Incomplete Payout***: **Revenue Ruling 70-336**: If B can give up/acquire X% of A’s

 working interest before full payout, no drilling deductions for X% of costs

 Reversion before full payout

 **Ex**: “100% to A until A recoups costs and B has ORIH. BUT, B can convert B’s

 ORIH to a 50% working interest if X barrels/day is produced”

 50% of A’s costs are deductible

 50% of A’s costs are capitalized

 **Ex**: B (lessee) assigns 100% of working into to driller (A). After A recovers all

 costs, 50% of working interest reverts to B. BUT, A retained ORIH with option

 to convert it to a 50% working interest when production equals $2M. In Y1, A

 incurs $10 of IDC & has $3 of deprec. deductions on equipment

 **A’s POV**: 50% of A’s costs are deductible

 50% of A’s costs are capitalized

 ***Deductions Limited to Working Interest Earned***: **Revenue Ruling 71-206**

 **Ex**: A agrees to fund 100% of development costs in exchange for 25% interest

25% of A’s costs are deductible

75% of A’s costs are capitalized

 ***Full Recoupment***: **Revenue Ruling 71-207**

 **Ex**: A commits to fund 100% of development costs and BC do NOT get paid

 until A recoups 100% of development cost

100% of A’s costs are deductible

 ***No On-Going Interest But Full Payout***: **Revenue Ruling 75-446**

 **Ex**: A commits to fund 100% of dev. costs but must recoup 200% of his costs

100% of A’s costs are deductible (even though A has no EI post-payout)

 ***Payout From Multiple Properties***: **Revenue Ruling 80-109**: If A has a 75%

 interest in 2 separate, non-contiguous tracts and A gest payout from one tract,

 capitalize 25% of A’s costs

 **Ex**: **2 non-contiguous tracts**. “100% to A until A recoups costs that A spent

 developing BOTH tracts, then 75% to A”

 75% of A’s costs are deductible bc it’s possible for A to not hold 100% of

 his interest until A reaches payout for each tract

***Production Payments***

**Concept**: lessee sells a production payment to B in exchange for cash

**Pre-IRC 636**: **Thomas v. Perkins**: income paid is excluded from payor’s income

***Carveouts***

**IRC 636(a)**: if PP is carved out of a mineral interest in exchange for cash, then:

 **1) If Pledged For Development**: Apply pool of capital doctrine

 **A) Lessee/Seller**: **i) At Start**: Non-recognition under POC

  **(Holder of** **Effect**: no deduction for costs PP funded

  **Burden Interest)** **ii) At Production**: Ordinary, depletable income

 **B) Buys/Payor of Cash**: **i) At Start**: Apply Pool of Capital Doctrine

 **(Holder of PP)** **Effect**: Gets basis in the PP

 **ii) At Production**: Ordinary, depletable income

 **Pledge For Development**: **RR 1.636-1(b)(1)**: NOT pledged for development

 if the PP is pledged to E&P of properties that are NOT on the same lease

 **Ex**: In Y1, lessee carves out a PP of $500. Lessee must use the $500 that

he gets to for additional development on another O&G lease lessee has

 **Effect**: NOT pledged for development

 **Ex**: Developer (A) has lease and carveout 1/8 PP up to $175 and sold

to B for $150. PP IS dedicated to E&P. In Y1, $200 O&G is produced

 **A’s POV**: **At Start**: $150 treated as contrib. to POC (non-recognition)

 **At Production**: $175 ordinary, depletable income

 **B’s** **POV**: **At Start**: $150 treated as contrib. to POC for EI (gets basis)

 **At Production**: $25 ordinary, depletable income

 **2) If NOT Pledged For Development**: Treat as a **mortgage loan, NOT an EI**

 **A) Lessee/Developer**: **i) At Start**: No inclusion (treat as cash from loan)

 **ii) At Production**: include ALL PP in income

 **Effect**: Deduct PP as loan interest payments

 **B) Buys/Payor of Cash**: **i) At Start**: Treat as cash paid as a loan to lessee

 **Effect**: Gets basis in the PP

 **ii) At Production**: Treat as repayment of loan

 “interest” on the loan as income

 **Ex**: Developer (A) has lease and carveout 1/8 PP up to $175 and sold

to B for $150. PP is NOT dedicated to E&P. In Y1, $200 O&G is produced

 **A’s POV**: **At Start**: $150 treated as loan proceeds (non-recognition)

 **At Production**: $200 of ordinary, depletable income

 ($25) deductions as repayment of “interest”

 **B’s** **POV**: **At Start**: $150 treated as loan (non-recognition, gets basis)

 **At Production**: $25 included as repayment of “interest”

***Retained PP On Sale (ABC Transactions)***

**Issue**: **Lessee**: can sell his property (gets GC treatment)

 **Developer**: can finance the deal with pre-tax dollars (PP income that he’d

 get is excluded from income under pre-**IRC 636(b)** law)

**IRC 636(b)**: treat as a **purchase money mortgage**

 **Effect**: If TP retained a PP when he sold the mineral estate, treat the PP like a

 mortgage loan

 **1) Seller**: **A) At Sale**: **i) Sales Price**: Normal gain/loss rules

 **(Developer)**  **ii) PP (As Whole)**: treat as installment payment

 **Effect**: each year, add to purchase price/AR

 **B) At Production**: treat PP that seller gets as a repayment of

 principal/interest from a loan

 **2) Buyer**: **A) At Sale**: **i) Sales** **Price**: Capitalized into the lease

 **(Lessee)**  **ii) PP (As A Whole)**: Capitalized into the lease as

 buyer makes the PP payment

 **Effect**: each year, add to purchase price/AR

 **B) At Production**: include the entire PP in income & deduct

 PP as loan/interest repayment

ABC Transactions

 Step 1

 **————Working Interest————>**

 Lessee Developer

Step 2 **/\**  **|** **<————Cash (Sales Price)———**

 **|** **|** **<———Production Payment———**

 **|** **|**

 **|** **Production**

 **Cash Payment**

  **| |**

 **|** **|**

 **|** **\/**

 Investor

**Ex**: ABC transaction. Lessee (A) transfers lease to Developer (B) for $300 and retained a 1/8 production payment up to $175. In Y1, $200 O&G produced

 **Chart**:

 **————Working Interest——————>**

 Lessee Developer

 **<————Cash ($300)—————————**

 **<—Production Payment ($up to $175)——**

**A’s POV**: **At Sale**: $300 AR on sale (plus $175 PP)

 $175 production payment is PM mortgage (creates extra AR)

 **At Production**: $25 included as repayment of principal & interest

**B’s POV**: **At Sale**: $300 capitalized into lease

 $175 capitalized into the lease

 **At Production**: $200 ordinary, depletable income

($25) deduction for repayment of principal & interest

***Retained PP On Lease***

**IRC 636(c)**: if lessor retains a PP when he enters a lease, then:

 **1) Lessor POV**: **A) At Lease**: Treat PP as a bonus – ordinary, depletable income

 **B) At Production**: Treat PP as an installment bonus as paid

 **2) Lessee POV**: **A) At Lease**: Capitalize into the lease

 **B) At Production**: Capitalize into the lease as paid

**Ex**: Lessor (A) leases to Developer (B) for $100 bonus, 1/8 royalty, and 1/8 PP up to $175. In Y1, $200 O&G is produced

**A’s POV**: **At Sale**: $100 ordinary, depletable income (bonus)

 **At Production**: $25 ordinary, depletable income (royalty)

 $25 ordinary, depletable income (production payment)

**B’s POV**: **At Sale**: $100 capitalized into the lease (bonus)

 **At Production**: $175 ordinary, depletable income

 $25 capitalized into lease (production payment made)

**Intangible Drilling & Development (IDC) Costs**

***Generally***

**Issue**: Without special rules, IDC would bc capitalized into the lease

**Definition**: ALL intangible and/or non-salvagable costs of drilling

 **Ex**: Labor, fuel, supplies, hauling that are necessary to produce O&G

***Foreign IDC***

**IRC 263(i)**: capitalized & amortized ratably over 10 years

***Domestic IDC***

**IRC 263(c)**: Regs give TP election to deduct IDC in **House Concurrent Resolution 50**

**Immediate Deduction**: optional **immediate deduction for IDC** if TP elects

**Amount of Deduction**:

 **1) Non-Integrated Oil Companies**

 **IRC 291(b)(1)(A)**: Can immediately **deduct 100%** of IDC Costs

 **Ex**: Lessor (A) enters lease with Corp B (C and D jointly own (50-50)). Corp

 B gets entire working interest, A retains 1/8 royalty

 **Corp B’s POV**: CAN make IDC election **C’s POV**: Can NOT make election

 **D’s POV**: Can NOT make election

 **2) Integrated Oil Companies**

 **IRC 291(b)(2)**: Can immediately **deduct 70%** of IDC Costs

 **Deduct 30%** of IDC Costs ratably over **60 months**

 **Definition**: **IRC 291(b)(4)**: Owns E&P, refining, AND Marketing

 NOT the same thing as a “major integrated company”

 **Ex**: Lessor (A) leases with Corp B (integrated oil company under **IRC**

 **291(b)(4)**). Corp B gets entire working interest, B retains 1/8 royalty

 **Corp B’s POV**: CAN make IDC election for 70% of IDC

 Can NOT make IDC election for 30% **(amortize over 30 months)**

***The Election –*** **RR 1.612-4(a)**

***Who***: anyone who holds an EI gets IDC deduction

 **Ex**: operator, working interest owner, farm-in TP, co-working interest TPs, corps

 **Banned**: **Mere royalty, ORIH, NPI holders do NOT** get an IDC election **!!!**

 **Effect**: Capitalized into the lease

 **Ex(1)**: Lessor (A) & lessee (B). A retains 1/8 royalty, B got entire working interest

 **B’s POV**: CAN make an IDC election **(working interest owner)**

 **Ex**: Same as **Ex(1),** but B assigns working int. to Farmin (C). B retains 1/16 ORIH

 **B’s POV**: Can NOT make IDC election

 **C’s POV**: CAN make an IDC election

 **Ex**: Same as **Ex(1)**, but B assigns working int. to Farmin (C). B retains a 50% NPI

 **B’s** **POV**: Can NOT make IDC election

 **C’s POV**: CAN make an IDC election

 **Ex**: Same as **Ex(1)**, but B assigns working int. to Farmin (C). B retains $100 PP

 **C’s POV**: CAN make an IDC election

 **Ex(2)**: Lessor (A) leases to lessee (B). A retains 1/8 royalty, B gets 100% working

 interest. B assigns 25% working interest to C to drill, but C holds 100% working

 interest until costs are recovered

 **B’s POV**: Can NOT make IDC election

 **C’s POV**: CAN do IDC election **(100%)**

 **Ex**: Same as **Ex(2)**, but C gets 25% working interest & funds 100% of drilling cost

 **C’s POV**: CAN make IDC election for 25% of costs

 Capitalizes 75% of drilling costs

***Partnerships***: **IRC 703(b)**: Partner elects for his own property

 PA elects for the PA’s property

 **Ex(3)**: Lessor (A) leases with B & C (each 50% working int.). A retains 1/8 royalty

 **A’s POV**: Can NOT make IDC election **C’s POV**: CAN make IDC election

 **B’s POV**: CAN make an IDC election

 **Ex**: Same as **Ex(3)**, but parties elect to be treated as a tax PA under **IRC 761(a)**

 Partnership, NOT the partners, make the election

***What***: IDC costs have no salvage value

 **Pre-Lease** **Costs**: election covers costs incurred before TP actually got the lease

 **Ex**: Legal fees for negotiating or drafting lease is IDC

 **Ex**: **RR 1.612-4(a)(2):** Costs of constructing dirt road to drill site is IDC

 **Ex**: Costs to rent trucks to transport materials to drill site is IDC

 **BUT Ex**: NOT IDC if trucks were already purchased

 **Ex**: costs of physical equipment are NOT IDC, but installation costs are

 **Hiring Another**: If A hires B to do work, but only A has an EI, A can deduct the

 costs of hiring and paying B

 **Ex**: Lessor (A) leases to lessee (B). A gets 1/8 royalty, B gets 100% working

 interest. B contracts with C to drill a well for $10/foot

 **A’s POV**: Can NOT make IDC election **C’s POV**: Can NOT make IDC election

 **B’s POV**: CAN make IDC election

 **Ex**: Same, but B made “turnkey K” with C (C must deliver finished well for $100)

 **A’s POV**: Can NOT make IDC election **C’s POV**: Can NOT make IDC election

 **B’s POV**: CAN make IDC election **(can deduct 100% of turnkey contract)**

 **Possible G&G Costs**: See Question 3, Page 354 (CHP 6, Page 94 Answers, 2)

***How***: Claim IDC as a deduction on **TP’s 1st tax return** with an IDC cost

 **Failure to Deduct**: TP will be deemed to have capitalized IDC costs

 **Titus Oil & Investment**: TP’s original tax return is controlling

 If TP is still within extension period on tax return, can change his election

 If not, TP can NOT change his election

 **California** **Oil**: Once TP capitalizes/deducts, TP is stuck with that treatment

***Dry Holes***

**RR 1.612-4(b)(4)**: If TP elected to capitalize IDC costs but, later, TP drills a dry hole, TP can make a new election to deduct ALL dry hole costs (including IDC costs)

 TP’s election to deduct dry hole cost ***trumps*** TP’s election to capitalize IDC costs

***Alternative Minimum Tax***

**IRC 59(e)**: TP can elect to spread out IDC deductions over 60 months if TP wasn’t to avoid the alternative minimum tax

***Offshore IDC***

**Process**: 1) Exploratory Well 4) P&A of discovery well

 2) TP acquires offshore leases 5) Drills delineation wells

 3) TP drills a discovery well 6) Installs platforms

***Exploration***

**Issue**: Are these G&G or IDC Costs?

**Standard Oil**: As long as the well **could produce**, it is an IDC cost

 TP’s intent to actually complete produce is irrelevant

 Just bc a well gets G&G data is NOT controlling

**Sun Case:** IDC has expansive definition that includes all wells that **could produce** and need NOT be limited to exploratory drilling —> No 2 prong test

 IDC deduction is most needed bc this is the most risky stage

**Revenue Ruling 88-10**: Delineation wells ARE an IDC Cost

 **Exception**: IRS will argue G&G cost if there’s no lease in place when TP drill one

***Development***

**Building Phases**: 1) Land Phase (Design)

 2) Land Phase (Construction)

3) Water Phase (Construction)

**Revenue Ruling 70-596**: Yes IDC cost to transport a platform from onshore assembly to the erecting site

**Exxon Corp v. US**: If it is an intangible cost, it does NOT matter where it took place

 Land Phase (Design) has lots of IDC

 Land Phase (Construction) has less IDC bc raw materials (Steel) are salvageable

**Gulf Oil**: Platforms, themselves, have no salvage value and ALL is IDC

**Louisiana Land & Exploration**: **First Use Test**: Yes IDC if the **first use** was for drilling and development —> Applies for “modules platforms”

***Development or Production Costs?***

**Issue**: If TP spends money on production, it is NOT IDC bc too far along in the production process bc no longer in the “development” phase

**PKM Petroleum**: **NOT IDC**: Cost to improve/sustain production in a producing well

**Monrovia** **Oil**: **Yes IDC**: Costs to get production from a reservoir that was not previously producing

**Producers Chemical**: **Yes IDC**: Fracking costs are IDC

 Getting O&G from a part of the reservoir that has never before been touched

**Revenue Ruling 69-583**: **Yes IDC**: Costs to create a water field for initial production in the area

**IRS Technical Advice Memo 97-28-004**: **Yes IDC:** Costs to convert producing wells into injecting wells

**GCM 39619**: **Yes IDC**: Drilling injection wells

**Revenue Ruling 82017**: **NOT IDC**: Costs to drill CO2 “source wells” for 2ndary ops NOT IDC bc wells don’t relate to O&G, although CO2 will be used in O&G project

**O&G Property Unit**

***General Rule***

**IRC 614(a)**: In computing depletion, “property” means:

***1) Each Separate Interest Owned by TP***

 **Interest**: **IRC 614-1(a)(2)**: “Interest” means economic interest

 **Separate Interest**: ***A) Different Ownership Percentages***

 Yes separate interest if TP has different ownership

 percentages in the same tract

 **Revenue Ruling 77-176**: A owns 100% working interest

 in drill site & a 50% working interest in outside acreage

 **Court**: A has 2 separate interests

 ***B) Non-Simultaneous Conveyances***

 **Revenue Ruling 68-566**: yes separate interests if leases

 /lands were not conveyed at exactly the same time

 **Sence Case**: yes separate if got a working interest from

 Contract 1, & a royalty interest in same land from K 2

***2) In Each Mineral Deposit***

 **Economic Interest**: **Revenue Ruling 77-188**: NOT a separate interest if TP has

 an EI in land with no established mineral deposits

 **Horizontal Stratas**: **Gulf Oil**: TP can NOT abandon certain horizontal stratas

 **PROF**: Court did NOT decide whether an attempt to claim a different

 mineral deposit was “separate interests” bc of potential mineral deposits

***3) In Each Separate Mineral Tract —*** **RR 1.614-1(a)(5)**

 **General meaning**: “tract of land” is merely the physical scope of the land

 **Same Conveyance**: **Single Tract**: Same tract for all **CONTIGUOUS** tracts

 conveyed in a **single** **conveyance** (or separate conveyance, but at the same

 time) **from** the **same owner**

 **Berkshire** **Oil**: Properties touching at the corner are NOT contiguous

 **Freeman**: Different primary terms, alone, NOT create separate interest

 **Ex**: A acquired working interests in 3 mineral leases on 3 contiguous tracts

 of land at same time from same lessor, each had different primary term

 A has 1 property interest **(See Freeman)**

 Ex: A got working interests in 3 mineral leases on 3 contiguous tracts at 3

 different times from the same lessor. A did this as part of an integrated

 plan to get separate properties for tax purposes

 A has 1 property under **RR 1.614-1(a)(3)**

 **Separate Conveyance**: **Separate tracts**: Separate if separate conveyance

 from separate owners, even if in the same time, even if contiguous

 **Ex**: A acquired working interests in 3 mineral leases on 3 contiguous tracts

 of land at different times from the same lessor

 A has 3 different property interests

 **Ex**: A acquired working interests in 3 mineral leases on 3 contiguous tracts

 of land at different times from the different lessors. A got in same lease

 A has 3 different property interests **(See American Smelting & Refining)**

 **Different Mineral Deposits**: **Separate Tracts**: If TP owns 2+ mineral deposits,

 each is a separate tract

 **Ex**: A acquired working interests in 3 mineral leases on 3 contiguous tracts

 of land at different times from the different lessor. Each tract was part of

 the same mineral deposit (A knew of these deposits at lease)

 A had 3 property interests

 **But See Ex**: A got working interests in 3 leases on 3 contiguous tracts

 of land at different times from the different lessor. Each tract was part of

 the same mineral deposit. Years later, A finds out there’s 2 extra separate

 mineral horizons on each tract

 A had 9 property interests

 **Dissimilar Interests**: **Separate Tracts**: **Rev Ruling 68-566**: If TP has dissimilar

 rights in the same tract, separate tracts

 **Ex**: A got working interests in 3 mineral leases on 3 contiguous tracts at 3

 different times from the same lessor. A acquired each on the same day

 from Texas ROC in successful bids

 A had 3 properties since lease was entered at separate times

 **Ex**: A acquired working interests in 3 leases on 3 contiguous tracts at same

 time from 3 different lessors. A transfers 1/4 interest in each lease to B in

 a single transaction

 B has 3 properties

 **Ex**: Same, but lease had the exact same terms

 B had 3 properties

 **Ex**: A gets 1/4 royalty interests and entire working interests in 3 leases on

 3 contiguous tracts at 3 different times from same lessor

 A has 6 separate properties (argument A has 4 properties)

 **Leases/Sales**: **Single Tract**: Lease/sale of 2 CONTIGUOUS tracts to a single

 lessee/buyer means lessee/buyer has 1 property

 **Ex**: A got free interests in 3 tracts on 3 contiguous tracts at same time

 from 3 different sellers. A sells 1/4 interest in each tract to B at same time

 B has 1 property **(see RR 1.614-1(a)(5), Ex 6)**

 **Gifts/Inheritances**: **Separate Tracts**: **RR 1.614-1(a)(5), Ex 7**: If donee gets 2

 separate properties donor from a gift in a single conveyance, separate tracts

 **Ex**: A acquired working interests in 3 leases on 3 contiguous tracts at same

 time from 3 different lessors. A gifts the three leases to is GC

 GC has 3 properties bc GC will get a carryover basis

***Aggregation Rules***

***Operating Interests***

**Default**: **IRC 614(b)(1)(A)**: All TP’s “operating interests” in each separate tract are **combined into 1 single property**

**Exception**: **IRC 614(b)(1)(B)**: Can NOT combine operating interests from one tract with operating interests in another tract

 **Ex**: A acquires fee interests in 2 contiguous properties from different grantors at

 same time. Tract 1 has 3 deposits (P1A, P1B, and P1C), Tract 2 has 1 deposit

 (P2A). What happens if there is no aggregation?

 A has 4 separate properties interests

 **Ex**: Same facts. Can A combine Tract 1 interests with tract 2 interests?

 No under **IRC 614(b)(1)(B)** bc they are separate tracts **(Tract 1 & Tract 2)**

**Election**: **IRC 614(b)(2)**: If TP has 2+ operating interests in a single tract, TP can elect to treat them as separate properties

 **True v. US**: Substantial compliance with the election is enough (formal notice)

 **Ex**: A acquires fee interests in 2 contiguous properties from different grantors at

 same time. Tract 1 has 3 deposits (P1A, P1B, and P1C), Tract 2 has 1 deposit

 (P2A). A elects to treat P1C separately. How many properties does A have?

 A has 3 separate properties **(P2A, P1C, and combo of P1A and P1B)**

**Timing**: **RR 1.614-8(a)(3)**: unless in a pool/unit, TP must make the election by the later of TP’s first year or TP’s first year with any O&G E&P costs

**ONLY 1 Combo**: TP can ONLY have 1 combo **per tract**

**Left-Over Properties**: **RR 1.614-8(a)(1)**: if TP elects to combine properties, interests that TP did not elect to treat separately will be combined

**Non-Operating Interest**: **NEVER combined with operating Interests!!!!!!**

 **Definition**: **Royalties!**

**Later-Discovered Operating Interests**: If TP made an election, later discovered or acquired new operating interests in same tract, those new operating interests are:

 **1) If No Combo In Tract**: Treat As Separate Unless TP Elects to Combine

 **Ex**: TP owns ABC. All are separate. Later, D is discovered

 D is treated as a separate property with ABC unless TP elects to

 combine with either A, B, OR C

 **2) If Yes Combo In Tract**: Treat As Part Of Combo Unless TP Elects to Separate

 **Ex**: TP owns ABC. A is separate, BC are combined. Later, D is discovered

 D is treated as part of BC combo unless TP elects to treat D separately

 **Ex**: A acquires fee interests in 2 contiguous properties from different

 grantors at same time. Tract 1 has 3 deposits (P1A, P1B, and P1C), Tract 2

 has 1 deposit (P2A). A elects to treat P1C separately. Later, A discovers

 new deposit on Tract 1 (P1D). How many properties does A have?

 A has 3 separate properties **(P2A, P1C, and combo of P1A, P1B & P1D)**

 unless A elects to treat P1D separately **(can NOT combo P1D with P1C)**

***Non-Operating Interests***

**General Rule**: **NEVER combine** non-operating interests with operating interests

**Non-Operating Combos**: **IRC 614(e)**: CAN combine operating interests with other operating interests if: 1) TP owns 2+ non-operating interests;

 2) In a single tract or in adjacent tracts in close proximity;

 3) And, the primary purpose of combo is not tax avoidance

**Ex**: A acquires fee interests in 2 contiguous properties from different grantors at same time. Tract 1 has 3 deposits (P1A, P1B, and P1C), Tract 2 has 1 deposit (P2A). A elects to treat P1C separately. A leases a portion of Tract 1 (with no existing mineral deposits) to B in exchange for A getting a royalty interest. Later, B discovers a new mineral deposit (P1D).

 A has 3 separate properties **(P2A, P1C, and combo of P1A and P1B)**

 A has non-operating interest in P1D **(can NOT combo with operating interests)**

***Pooling & Unitization***

**General Rule**: **IRC 614(b)(3)(A)**: If TP’s operating interests are in a voluntary or compulsory pool, then treat the interests in that pool/unit as a single property

 If TP’s interest is pulled out of a combo, then treat it as a separate property

 **Ex**: TP owns ABC. All are combined. B is unitized

 B is now treated as a separate property, BC are still in a combo

**Non-Recognition**: **Belridge** **Oil**: Formation of a pool/unit is a non-recognition event

**Limits**: **1) Compulsory Pools**: Apply General Rule

 **2) Voluntary** **Pools**: **IRC 614(b)(3)(B)**: ONLY apply the general rule if:

 A) The pooled unit(s) are in the same deposits, or in different

 deposits but pooling is economically/geologically logical; and

 B) The pooled tracts are contiguous or close proximity to each other

**Ex**: A owns WI in 3 leases on 3 non-contiguous tracts on same reservoir. Unit/pool for A to combine tracts with others. A gets 5% of income/loss from unit

 **Compulsory Pool**: A owns 1 property through unit’s duration

 **Voluntary Pool**: A owns 3 separate properties unless in tracts in close proximity

**Cost Depletion**

***Generally***

**Concept**: use the mineral’s basis, calculate expected production, do a ratable deduction for each barrel of O&G produced

**No Production**: **Lessor’s POV**: **Yes Cost depletion**

  **Lessee’s POV**: **No Cost depletion**

**General Rule**: **IRC 611(a)**: Yes cost depletion for O&G wells

**Changes in Estimates**: **IRC 611(a)**: if TP finds his “Recoverable Units” is less/greater than his prior estimate, then TP must revise Recoverable Units (but NOT TP’s basis)

 **RR 1.611-2(c)(2)**: If TP later finds Recoverable Units that is materially greater or

 less than his prior estimate, TP must revise “Remaining Recoverable Units”

**Depletable Accounts**: **RR 1.611-2(b)(2)**: TP must keep a separate depletion account to record costs, basis, and improvements to the property

 Then, TP must annually credit the mineral depletion accounts for depletion

**Leases**: **IRC 611(b)**: **Twin Bell**: equitably apportion depletion between lessor/lessee

**Formula**: **RR 1.611-2(a)(1)**: Depletion of TP’s basis is found by:

 **1) Dividing**: **A) Basis**

 **Basis**: **IRC 612**: TP’s basis under **IRC 1011**, **IRC 1012**, **IRC 1016**

 **Installment Bonuses**: Each year, add the amount of bonus

paid to lessee’s basis

**Clement Case**: If lump-sum transaction of depletable & non-

depletable assets, basis for each asset is its FMV

 Basis is the amount paid in an arm’s length transaction

 **B) By [Total] “Number Of Units Remaining As Of Year”**

**RR 1.611-2(a)(3)**: i) “Number of Units Remaining At Year End

 To Be Recovered (or Not Yet Sold),” plus

 ii) “Number of Units Sold In that Year”

 **2) Multiply this by “Number of Units Sold In That Year”**

 **RR 1.611-2(a)(2)**: **A) If cash method**, include all cash received in that year

 **B) If accrual method**, include all amounts sold (but not

 necessarily received) in that year

**Total Recoverable Units**: **RR 1.611-2(c)(1)**: TP must estimate the “total recoverable units” Rly known or on good evidence is believed to exist

 **Definition**: “Recoverable units” includes:

 1) O&G “in sight” **4) Proved Reserves** (drill actually touched O&G)

 2) O&G “blocked out” **5) Probable Reserves** (believed to exist on good

 3) O&G “developed” evidence, but not actually known)

 **Safe Harbor**: **Rev Procedure 2004-19**: “Total Recoverable Units” can just be

 **105% of proved reserves**

 **Black Gold Petroleum**: Once TP decides that he will not produce X Type of O&G,

 or that TP will abandon X Type of O&G, TP’s “Total Probable Reserves” should

 NOT include X Type of O&G (TP should also get an immediate basis deduction)

 Total Recoverable Units should NOT include O&G with no market or with

 unrealistic/uneconomic refining costs

***Formulas***

***Normal Formula***

 AB: Property’s AB

 S S: Units/value of Units sold

AB x ————— = Depletion Allowed U: Units/value of Units Remaining

U + S in Year X

***Bonuses***

 Bonus

AB x ——————————————— = Depletion Allowed on Bonus

 Bonus + Expected Total Royalties

 Royalty Rate

 x Estimated Reserves

 x Price Per Barrel

 Expected Total Royalties

***Net Profits Interests (NPIs)***

 NPI Paid in THIS Year

AB x ———————————————————— = Depletion Allowed on NPI

 NPI Paid in THIS Year + Expected Total NPI

 **Ex**: In Y1 lessee subleased Land ($20 AB) to M for a 20% NPI. Estimated value of

 NPI is $100 from 50,000 barrels. $0 NPI paid in Y1. $5,000 NPI payment in Y1

 Basis in NPI: $20,000 Total NPI Value: $100,000

 NPI Income in Y2: $5,000 Cost Depletion in Y2: $1,000

 NPI Value at Y2 End: $95,000

 $5,000

 $20,000 x —————————— = $1,000

 $5,000 + $95,000

***Advanced Royalties***

**General Rule**: If recoupable and based on a specific number of units, compute cost depletion based on those units

 **Lessor’s POV**: Takes depletion in the year that advanced royalties are received

**Expiration**: If the right to drill expires before royalties have been paid, lessor must repay extra cost depletion he got & report money he got paid as ordinary income

**Example**: ***Normal Cost Depletion***

 **Ex**: O&G sells $20/barrel. In Y1, lessor got $300,000 bonus, 1/6 royalty. Lessor

 had $10,000 basis in mineral estate. Lessee spent $5,000 on lease fees. Total

 Estimated Reserves of 240,000 Barrels. No production. In Y2, 12,000 barrels

 produced. In Y3, lessee revises Total Estimated Reserves to 480,000. 12,000

 barrels produced

***Lessor POV Lessee POV***

Basis $10,000 Basis $305,000

Bonus $300,000 Units Sold in Y2 0 Barrels

Royalty Rate 16.67% (1/6) Estimated Reserves 240,000 barrels

Estimated Reserves 240,000 barrels Price/Barrel $20

Price/Barrel $20 Cost Depletion in Y1 **$0**

Estimated Royalties **$801,600**

 **0 Sold**

 **Royalty Rate 16.67% $305,000 x ——————— = $0**

 **x Estimated Reserves 240,000 0 + 240,000**

 **x Price Per Barrel $20**

 **Expected Total Royalties $801,600**

Cost Depletion in Y1 **$2,723**

 **$300k**

 **$10k x ———————— = $2,723**

 **$300k + $801,600**

Basis Y2 Start **$7,277** Basis Y2 Start **$305,000**

 **Basis Y1 Start $10,000 Basis Y1 Start $305,000**

 **(Y1 Depletion) ($2,723) (Y1 Depletion) ($0)**

 **Basis Y2 Start $7,277 Basis Y2 Start $305,000**

Y2 Production 12,000 Barrels Y2 Production 12,000 Barrels

Remaining Reserves **228,000 Barrels** Remaining Reserves **228,000 Barrels**

 **Estimated Reserves 240,000 Estimated Reserves 240,000**

 **(Barrels Produced in Y1) (0) (Barrels Produced in Y1) (0)**

 **(Barrels Produced in Y2) (12,000) (Barrels Produced in Y2) (12,000)**

 **Remaining Reserves 228,000 Remaining Reserves 228,000**

Cost Depletion in Y2 **$364** Cost Depletion in Y2 **$15,250**

 **12,000 barrels 12,000 Sold**

 **$7,277 x ————————— = $364 $305k x ——————— = $15,250**

 **12,000 + 228,000 12,000 + 228,000**

Basis Y3 Start **$6,913**  Basis Y3 Start **$289,750**

 **Basis Y1 Start $10,000 Basis Y1 Start $305,000**

 **(Y1 Depletion) ($2,723) (Y1 Depletion) ($0)**

 **(Y2 Depletion) ($364) (Y2 Depletion) ($15,250)**

 **Basis Y2 Start $6,913 Basis Y3 Start $289,750**

Estimated Reserves 480,000 Estimated Reserves 480,000

Y3 Production 12,000 barrels Y3 Production 12,000 barrels

Remaining Reserves **456,000** Remaining Reserves **456,000**

 **Estimated Reserves 480,000 Estimated Reserves 480,000**

 **(Barrels Produced in Y1) (0) (Barrels Produced in Y1) (0)**

 **(Barrels Produced in Y2) (12,000) (Barrels Produced in Y2) (12,000)**

 **(Barrels Produced in Y3) (12,000) (Barrels Produced in Y3) (12,000)**

 **Remaining Reserves 456,000 Remaining Reserves 456,000**

Cost Depletion in Y3 **$177**  Cost Depletion in Y3 **$7,429**

 **12,000 barrels 12,000**

 **$6,913 x ————————— = $177 $289,705 x ——————— = $7,429**

 **12,000 + 456,000 12,000 + 456,000**

***Aggregation Mid-Way Through the Year***

**Issue**: What happens if TP acquires a separate property half-way through the year that is aggregated with another property?

 **RR 1.611-2(a)(5)**: Compute cost depletion separately the part of the year that

 did not include the separate property

 Then, for remaining part of year, do cost depletion for aggregated property

 **Ex**: Property 1 (P1): *In Y1*, W buys 50% operating interest from lessee for

 $10,000. Property 2 (P2): *In July of Y2*, W buys the other 50% operating

 interest for $5,000. In Y1, W estimates 100,000 barrels. No production. In Y2,

 5,000 barrels produced. What happens in Y2?

***Bought P2 in January Bought P2 In July***

***Entire Year Property 1***

Basis Y2 Start $15,000 Basis $10,000

Units Sold in Y2 5,000 barrels Units Sold to June 5,000

Estimated Reserves 100,000 barrels Estimated Reserves 100,000 Barrels

Remaining Reserves **95,000** Remaining Reserves **95,000**

 **Estimated Reserves 100,000 Estimated Reserves 100,000**

 **(Barrels Produced in Y1) (0) (Barrels Produced in Y1) (0)**

 **(Barrels Produced in Y2) (5,000) (Barrels Produced in Y2) (5,000)**

 **Remaining Reserves 95,000 Remaining Reserves 95,000**

Depletion in Y2 **$750** Cost Depletion in Y1 **$500**

 **5,000 5,000**

 **$15k x ———————— = $750 $10k x ——————— = $500**

 **5,000 + 95,000 5,000 + 95,000**

Depletion Jan to June **$250**

  **$500 Cost Depletion in Y2**

  **x (6/12) Months**

 **$250 Depletion Jan to June**

Depletion July to Dec. **$250**

  **$500 Cost Depletion in Y2**

 **x (6/12) Months**

 **$250** **Depletion July to Dec.**

 ***Property 2***

 Basis $5,000

 Units Sold To Dec. 2,500

 Estimated Reserves 100,000 Barrels

 Remaining Reserves **97,500**

 **Estimated Reserves 100,000**

  **(Barrels Produced in Y1) (0)**

  **(Barrels Prod. to July) (2,500)**

 **Remaining Reserves 97,500**

Depletion July to Dec. **$125**

  **2,500**

  **$5,000 x ———————— =** **$125**

 **2,500 + 97,500**

**Example**: ***Separate Versus Aggregation Election Decision***

 **Ex**: W bought working interest for 2 mineral deposits for $15,000. Property 1

 (P1): $10,000 allocated to P1. *In Y1*, 6,000 produced. Total estimated reserves

 was 100,000. Property 2 (P2): $5,000 allocated to P2. *In Y1*, 4,000 barrels

 produced. Total Estimated Reserves is 80,000. Should W elect to aggregate or

 treat separately?

***Aggregation Treating Separately***

***Both Properties Property 1***

Basis Y1 Start $15,000 Basis in Y1 Start $10,000

Units Sold in Y1 10,000 barrels Units Sold in Y1 6,000

Estimated Reserves 180,000 barrels Estimated Reserves 100,000 Barrels

Remaining Reserves **170,000** Remaining Reserves **94,000**

 **Estimated Reserves 180,000 Estimated Reserves 100,000**

 **(Barrels Produced in P1) (6,000) (Barrels Produced in P1) (6,000)**

 **(Barrels Produced in P2) (4,000) (Barrels Produced in P2) —**

 **Remaining Reserves 170,000 Remaining Reserves 94,000**

Depletion in Y2 **$833.33** Cost Depletion in Y1 **$600**

 **10,000 6,000**

 **$15k x ———————— = $833.33 $10k x ——————— = $600**

 **10,000 + 170,000 6,000 + 94,000**

 ***Property 2***

 Basis in Y2 Start $5,000

 Units Sold in Y2 4,000

 Estimated Reserves 80,000 Barrels

 Remaining Reserves **76,000**

 **Estimated Reserves 80,000**

 **(Barrels Produced in P1) —**

 **(Barrels Produced in P2) (4,000)**

 **Remaining Reserves 76,000**

 Depletion in Y2: **$250**

  **4,000**

 **$5,000 x ———————— =** **$250**

 **4,000 + 76,000**

**Total Depletion**: $833.33 **Total Depletion**: $850

**Percentage Depletion (PD)**

**General Rule**: **IRC 613(a)**: For O&G wells, yes PD for:

 **1) A Certain Percentage**;

 **2) Of Gross Income**

***Gross Income***

**IRC 613A(d)(5)**: does NOT include bonuses, royalties received, advanced royalties, or other amounts payable without regard to production

**GCM 22730**: Gross income ONLY includes income from O&G extraction, NOT other income generated from the land

**Twin Bell**: Divide gross income between lessor and lessee

 **Formula**: Total Income

 (Royalties Paid to Lessor)

 Gross Income of Lessee

**No Sales at Well-Head**: **RR 1.613-3**: if no sales at the well-head, then gross income must be “representative of market/field price” (ROMFP)

 **Petroleum Exploration**: If no ROMFP, then use comparable methods to

 determine ROMFP (rollback method, FPC pricing method)

 **Exxon**: ROMFP can be greater than GI under a “netback sales price” method

**Bonuses**: Can **NOT deplete a bonus unless there’s production!!!**

***Limits on Percentage Depletion***

**General** **Rule**: Must calculate these limits ***EACH year***

**Prop Specific Limit**: **IRC 613(a)**: PD **can’t exceed 100%** of tax. inc. from the prop.

**Aggregate Limit**: **IRC 613A(d)**: PD **can NOT exceed 65%** of ALL TP’s taxable income, computed without regard to: 1) Depletion 3) **IRC 172** net loss

 2) **IRC 199** Deductions 4) **IRC 1212** Capital loss

 **Carryover**: **IRC 613A(d)(1)**: if exceeds 65% limit, the excess to future years

***Certain Percentage***

**Most Minerals**: **IRC 613(b)**: **1) 15**% PD Rate if from sale of oil deposits inside US

  **2) 14%** for all other minerals

 **Exception**: Do NOT apply for O&G well minerals

 **Louisiana Land & Exploration**: YES PD if TP produces “other minerals” (sulfur,

 CO2) from an O&G well (applies to integrated companies too)

**O&G Well Minerals**: **IRC 613A(a)**: no percentage depletion unless listed below:

 ***1) If Independent Producer & Royalty Owner***: **IRC 613A(c)(1)**: Yes PD on:

 ***A) Average Daily Production of Domestic O&G***

 **IRC 613A(a)(2)**: divide total production by number of days in year

 ***B) Up to “Depletable Oil Quantity”***

 **IRC 613A(c)(3)**: **i) If Gas**: **6,000 cubic feet/day**

 **IRC 613A(c)(4)**: Gas ÷ 6,000 = Barrels of oil

 **ii) If Oil**: **1,000 barrels per day**

 **Allocation**: **IRC 613A(c)(7)(A)**: allocate via IRC if

2+ TP’s share the 1,000 barrels/day

**NPIs**: **IRC 613A(c)(2)(A)(2)**: mess with this limit,

but solution is PP times total revenues

 **Revenue Ruling 92-25**: NPI calculation

 **IRC 613A(c)(2)(B)**: NPI calculation

 **Exceeding Limit**: **IRC 613A(c)(7)(A)**: Use cost depletion method for

 the excess (prof should give us)

 **Produces Oil AND Gas**: **IRC 613A(c)(7)(C)**: allocate taxable income in

 proportion to gross income from each

 ***C) 15% is the applicable rate***

 **Higher Rates**: 25% if O&G price is below $20/barrel

 ***2) If Refiner or Retailer***: **IRC 613A(d)(2-4)**: No PD

 **Concept**: produces O&G at the well but also refines (Exxon, Gulf, Texaco)

 **Refiners**: **IRC 613A(d)(3)**: refines O&G at an average of 75,000 barrels/day

 **Retailers**: **IRC 613A(d)(2)**: directly sells to a TP-run (or trademarked) outlet

 **Exception**: YES PD if retailer’s combined gross receipts from sales at ALL

of TP’s retail outlets is less than $5M

***Percentage Depletion is NOT Limited By Basis***

**Revenue Ruling 75-451**: PD CAN be in excess of basis, but, if it results in **negative basis**, then: 1) Gain on sale is NOT increased by the amount of negative basis

 **Ex**: TP bought minerals for $100, took $110 PD. Sells for $50

 AB $100 AR $50

 PD ($110) AB ($0) **—> NOT**

 AB ($10) **—> Negative Basis** Gain $50 **($10)**

 2) Capital Expenditures incurred after incurrence of the negative basis

 offsets to the extent of negative basis

 **Ex**: TP bought minerals for $100, took $110 PD, sells for $50

 after investing $30 of capital expenditure into the minerals

 AB $100 AB ($10) AR $50

 PD ($110) CE $30 AB ($20)

 AB ($10) AB $20 Gain $30

 3) Ordinary cost deductions are NOT reduced by negative basis

 **Ex**: TP got min. for $100, took $110 PD. Spent $50 in non-CE cost

 **Effect**: TP gets $50 deduction

**Example**: Property 1 (P1): A owns P1 (produces 365,000 barrels, $800,000 gross income, $700,000 expenses, $5,000 cost depletion). Property 2 (P2): A owns P2 (produces 365,000 barrels, $800,000 gross income, $500,000 expenses, $200,000 cost depletion). Property 3 (P3): B owns P3 (produces 730,000 barrels, $1.6M gross income, $1M expenses, $25,000 cost depletion). Taxable Income: A had taxable income of $400,000. B has taxable income of $50,000

 A B

 P1 P2 Total P3

Cost Depletion $5,000 $200,000 ————— $25,000

Annual Prod. 365,000 365,000 ————— 365,000 Barrels

Avg. Daily Prod. **1,000**  **1,000** **2,000 Barrels** **2,000 Barrels**

 **IRC 613A(c)(2)**

**Annual Production**  **365,000 730,000 730,000**

**———————— ———— = 1,000 ———— = 2,000 ———— = 2,000**

 **365 Days** **365 365 365**

1,000 Barrel Limit ———— ———— **500 Barrels 500 Barrels**

 **IRC 613(c)(8)(C)**

**Total Production (TP) 1,000 Barrels 730,000 1,000 Barrels**

**—————————— = % x % ———— = 50% x 50%**

**Barrels Produced (All) 1,000 Barrel Limit 1,460,000** **500 Barrels**

Gross Income $800,000 $800,000 $1,600,000 $1,600,000

(Direct Expenses) ($700,000) ($500,000) ($1,200,000) ($1,000,000)

Prop’s Tax. Income $100,000 $300,000 $400,000 $600,000

PD Rate 15% 15% ———— 15%

Tentative PD **$120,000** **$120,000** ———— **$240,000**

 **IRC 613(a)**

**Gross Income $800,000 $800,000 $1,600,000**

**x PD Rate x 15% x 15% x 15%**

 **Tentative PD $120,000 $120,000 $240,000**

Apply 100% Limit **$100,000** **$120,000** ———— **$240,000**

 **IRC 613(a)**

**Lesser of: Lesser of: Lesser of: Lesser of:**

 **1) Taxable Income $100,000 $300,000 $600,000**

 **2) Tentative PD $120,000 $120,000 $240,000**

Higher of CD or PD **$100,000 $200,000 —> CD is higher $240,000**

 **RR 1.613-1 so stop here!**

**Higher of:**

 **1) Cost Depletion $5,000 $200,000 $25,000**

 **2) 100% Limit $100,000 $120,000 $240,000**

Depletion Ratio **25%** ———— ———— **25%**

 **IRC 613A(c)(7)(A)**

 **Allowed 1,000 Barrel Limit (TP) 500 Barrels 500 Barrels**

**—————————————— —————— = 25% —————— = 25%**

**Total Average Daily Production (TP) 2,000 Barrels 2,000 Barrels**

Post-Ratio PD **$25,000** ———— ———— **$60,000**

 **IRC 613A(c)(7)(A)**

**Higher of CD or PD $100,000 $240,000**

 **x Depletion Ratio x 25% x 25%**

 **Post-Ratio PD $25,000 $60,000**

Apply 65% Limit ———— ———— ———— ————

 TP’s Tax. Income ———— ———— $400,000 $50,000

 (Cost Depreciation) ———— ———— ($200,000) ($0)

 Adj. Tax. Income ———— ———— $200,000 $50,000

 x 65% ———— ———— x 65% x 65%

Post-65% Limit ———— ———— $130,000 $32,500

PD Allowed **$25,000** ———— ———— **$32,500**

 **IRC 613A(d)(1)**

**Lower of: Lower of: Lower of:**

 **1) Post-65% Limit 1) $130,000 1) $60,000**

 **2) Post-Ratio PD 2) $25,000 2) $32,500**

CD Allowed ———— $200,000 ———— ————

Total Depletion $25,000 $200,000 $225,000 $32,500

Carried Forward **$0** **$0** ———— **$27,500**

 **Post-Ratio PD $25,000 $0 $60,000**

 **(PD Allowed) ($25,000) ($0) ($32,500)**

**Carried Forward $0 $0 $27,500**

**Example**: ***Net Profits Interests (NPI)***

**Ex**: Generally: Land produced 1,000,000 barrels, which sold for $20M. $9M of costs attributable to Land. Net profits of $11M. A’s POV: A owns Land. A has $900,000 of cost depletion. A’s share of production is 890,000 barrels (1M barrels x 89%). A’s taxable income is $10M. B’s POV: B owns 20% NPI. B owns a 20% NPI. B has $100,000 cost depletion. B got $2.2M of net profits ($11M x 20%). B’s percentage participation is 11% ($2.2M ÷ $20M gross revenue). B’s share of production is 110,000 barrels (1M barrels x 11%). B’s taxable income is $500,000

 Property A B

Participation Share  **IRC 613A(c)(2)(B)**  89% 11%

Cost Depletion $1,000,000 $900,000 $100,000

Annual Prod. 1,000,000 890,000 110,000

Avg. Daily Prod.  **2,740** **2,438**  **301**

 IRC 613A(c)(2)

**Annual Production**  **1,000,000 890,000 110,000**

**———————— ———— = 2,740 ———— = 2,438 ———— = 301**

 **365 Days** **365 365 365**

Depletable Oil Quant. 1,000 1,000 1,000 **A(c)(3)(B)**

Gross Income (**613(a)**) $20,000,000 $17,800,000 $2,200,000

Direct Expenses ($9,000,000) ($9,000,000) ($0) **——> NPIs** **don’t bear costs**

Taxable Income $11,000,000 $8,800,000 $2,200,000

PD Rate 15% 15% 15%

Tentative PD  **$3,000,000** **$2,670,000** **$330,000**

**Gross Income $20,000,000 $17,800,000 $2,200,000**

**x PD Rate x 15% x 15% x 15%**

 **Tentative PD $3,000,000 $120,000 $330,000**

Apply 100% Limit **$3,000,00**  **$2,670,000** **$330,000**

**Lesser of: Lesser of: Lesser of: Lesser of:**

 **1) Taxable Income $11,000,000 $8,800,000 $2,200,000**

 **2) Tentative PD $3,000,000 $2,670,000 $330,000**

Higher of CD or PD **$3,000,000 $2,670,000 $330,000**

 **RR 1.613-1**

**Higher of:**

 **1) Cost Depletion $1,000,000 $900,000 $100,000**

 **2) 100% Limit $3,000,000 $2,670,000 $330,000**

Depletion Ratio ——————  **41%** **100%**

 **Depletable Oil Quantity 1,000 Barrels 1,000 Barrels**

**———————————— —————— = 41% —————— = 330%**

**Total Av. Daily Prod. (TP) 2,438 Barrels 301 Barrels |**

 **Limit to 100%**

Post-Ratio PD —————— **$1,094,700** **$330,000**

**Higher of CD or PD $2,670,000 $330,000**

 **x Depletion Ratio x 41% x 100%**

 **Post-Ratio PD $1,094,700 $330,000**

Apply 65% Limit —————— —————— ——————

 TP’s Taxable Income —————— $10,000,000 $500,000

 (Cost Depreciation) —————— ($0) ($0)

 Adj. Tax. Income —————— $10,000,000 $500,000

 x 65% —————— x 65% x 65%

Post-65% Limit —————— $6,500,000 $325,000

PD Allowed —————— **$1,094,700** **$325,000**

**Lower of: Lower of: Lower of:**

 **1) Post-65% Limit 1) $6,500,000 1) $325,000**

 **2) Post-Ratio PD 2) $1,094,700 2) $330,500**

CD Allowed —————— —————— ——————

Total Depletion —————— $1,094,700 $325,000

Carried Forward —————— **$0** **$5,000**

 **Post-Ratio PD $1,094,700 $60,000**

 **(PD Allowed) ($1,094,700) ($32,500)**

**Carried Forward $0 $5,000**

**Example**: ***Oil AND Gas***

Ex: Generally: A has $5M taxable income. Property 1 (P1): A owns P1 (1.5B cubic feet of gas (250,000 barrel of oil) (1.5B ÷ 6,000), $7M gross income, $3M expenses, $200k cost depletion). Property 2 (P2): A owns P2 (produces 265,000 barrels, $19,080,000 gross income, $18M expenses, $350k cost depletion)

 Property P1 (Gas) P2 (Oil)

Cost Depletion —————— $200,000 $350,000

Annual Prod. (Barrels) 515,000 250,000 265,000

Avg. Daily Prod.  **1,411** **685**  **726**

**Annual Production**  **515,000 250,000 265,000**

**———————— ———— = 1,411 ———— = 685 ———— = 726**

 **365 Days** **365 365 365**

Gross Income —————— $7,000,000 $19,080,000

Direct Expenses —————— ($3,000,000) ($18,000,000)

Taxable Income —————— $4,000,000 $1,080,000

PD Rate —————— 15% 15%

Tentative PD —————— **$1,050,000** **$2,862,000**

**Gross Income $7,000,000 $19,080,000**

**x PD Rate x 15% x 15%**

 **Tentative PD $1,050,000 $2,862,000**

Apply 100% Limit —————— **$1,050,000** **$1,080,000**

**Lesser of: Lesser of: Lesser of:**

 **1) Taxable Income $4,000,000 $1,080,000**

 **2) Tentative PD $1,050,000 $2,862,000**

Higher of CD or PD —————— **$1,050,000 $1,080,000**

**Higher of:**

 **1) Cost Depletion $200,000 $350,000**

 **2) 100% Limit $1,050,000 $1,080,000**

Value of Depletion/Barrel **$1,533** **$1,488**

 **Higher of PD or CD $1,050,000 $1,080,000**

**———————————— ————— = $1,533 —————— = $1,488**

**Avg. Daily Production (Prop.) 685 Barrels 726 Barrels**

Depletable Oil Quant. —————— **685** **315**

**Allocate As Many Barrels As Possible (685) to the Well (P1 (Gas)) With the Higher Value of Depletion Per Barrel ($1,533), and Give Remainder (315) to the Well (P2 (Oil)) With the Lesser Value of Depletion Per Barrel ($1,488)**

Depletion Ratio —————— **100%** **43%**

 **Allowed 1,000 Barrel Limit (TP) 685 Barrels 315 Barrels**

**—————————————— —————— = 100% —————— = 43%**

**Total Average Daily Production (TP) 685 Barrels 726 Barrels**

Post-Ratio PD —————— **$1,050,000** **$464,000**

**Higher of CD or PD $1,050,000 $1,080,000**

 **x Depletion Ratio x 100% x 43%**

 **Post-Ratio PD $1,050,000 $464,400**

Apply 65% Limit —————— —————— ——————

 TP’s Taxable Income $5,000,000 —————— ——————

 (Cost Depreciation) ($0) —————— ——————

 Adj. Tax. Income $5,000,000 —————— ——————

 x 65% x 65% —————— ——————

Post-65% Limit $3,250,000 —————— ——————

PD Allowed —————— **$1,050,000 $464,000**

**Lower of: Lower of: Lower of:**

 **1) Post-65% Limit 1) $3,250,000 1) $60,000**

 **2) Post-Ratio PD 2) $1,050,000 2) $464,400**

CD Allowed —————— —————— ——————

Total Depletion —————— $1,050,000 $464,000

Carried Forward —————— **$0** **$0**

 **Post-Ratio PD $1.050,000 $464,400**

 **(PD Allowed) ($1,050,000) ($464,400)**

**Carried Forward $0 $0**

**Sales & Exchanges**

**Applicable Provision**: 1) **IRC 1001**: Realization requirement

 2) **IRC 1031**: Like-Kind Exchanges

 3) **IRC 1033**: Involuntary Conversions

 4) **IRC 1231**: Property Used in T/B

 5) **IRC 1245**: Recapture of Depreciable Assets

 6) **IRC 1254**: Recapture of IDC & Depletion

***Lease Or Sale?***

**Burnet v. Harmel**: Whether it’s a lease or sale depends on federal (NOT state) law

**Predominant Purpose**: In seeing if a lease or a sale, look to predominant purpose

 **West v. Commissioner**: Looking at the conveying docs, it is unclear whether TP

 entered into a sale/lease of either (or both) the minerals and surface

 The absence of forfeiture/habendum clause does NOT mean it’s NOT a lease

 **Predominant Purpose Test**: look to predominant purpose of a transaction

 to see if it’s a sale or a lease

 Here, court found it was a lease bc it had more characteristics of a lease

 **Ex**: Purpose was to produce O&G, TP retained royalty, only interest in

land was for O&G, lessee was in O&G business/obligated to drill

 **Revenue Ruling 69-352**: The presence (or absence) of a dominating purpose to

 develop O&G does NOT matter if TP got a bonus (lump sum payment) and

 retained a royalty interest

 TP’s continuing economic interest (or lack of EI) controls whether it’s a lease

 **Ex**: If A retains a non-operating interest that lasts the life of the property,

 it is a lease (NOT a sale)

***Charts***

**General Rule**: If A conveys an operating interest and retains any continuing non-operating interest in exchange for cash, it is a lease

 **Effect**: A’s cash received (i.e. bonus) is depletable income to A

***Yes a Lease Chart***

Property Owned

Before Conveyance Property Retained Property Conveyed

 1/8 Royalty 7/8 Working Interest

 NPI (40% of net profits from 8/8 Mineral Estate, subject

 *Retained* interest) to the NPI

Mineral Estate

 (8/8) 1/8 Royalty 7/8 Working Interest

 1/8 of 7/8 ORIH

 Pre-Payout: PP (first $50,000 Pre: 5/8 of 7/8 working

 of 3/8 of 7/8) interest

Post-Payout: 1/8 Royalty Post: 7/8 working interest

1/4 Royalty 3/4 Working Interest

NPI (25% Net Profits from (subject to the NPI)

 *Conveyed* Interest)

 1/7 of 7/8 ORIH 7/8 of 7/8 Working Interest

 NPI (15% of net profits from 7/8 of 8/8 Working Interest

 *Retained* interest) subject to the NPI

 1/8 of 7/8 ORIH

Working Interest Pre-Payout: Carried Working Pre: 5/8 of 7/8 Working

 (7/8) Interest (Non-Perpetual, no Interest

 Production until Payout)

Post-Payout: 1/4 of 7/8 Post: 7/8 of 8/8 Working

 Working Interest Interest

1/8 of 5/8 ORIH 5/8 Working Interest

1/4 of 7/8 Working Interest

**Ex**: In Y1, Lessor (A) leases O&G property to lessee (B). A gets $100,00 bonus, retains 1/8 royalty. In Y2, B transfers a 1/6 ORIH to C for $50,000 cash

 **Year 1**: Lease bc A holds a continuing interest **(Royalty)**

 **Year 2**: Sale bc B no longer holds a continuing interest

**Ex**: Same, but in Y2, B assigns 50% working interest to C for $50,000

 **Year 2**: Sale unless POC applies

**Ex**: Same, but in Y2, B transfers 50% working interest to C for $20,000 & 1/6 ORIH

 **Year 2**: Lease bc B holds a continuing interest (retained ORIH)

**Ex**: Same, but in Y2, B transfers 50% working interest to C for $20,000 & 1/6 ORIH. In Y3, B transfers 50% of B’s retained 1/6 ORIH to C for $10,000

 **Year 3**: Sale bc B bc B no longer has a continuing interest

**Ex**: Same, but in Y2, B transfers 50% working interest to C for 50% NPI of C’s share

 **Year 2**: Lease **(NPI retained is a royalty & continuing interest)**

***Yes a Sale Chart***

Property Owned

Before Conveyance Property Retained Property Conveyed

 5/8 Minerals 3/8 Minerals

 7/8 of 8/8 Working Interest 1/8 of 7/8 Royalty

 1/8 of 8/8 Royalty

 Pre-Payout: Carried Working Pre: 7/8 of 8/8 Working

Minerals Interest (Non-Perpetual, no Interest

 (8/8) Production until Payout)

Post-Payout: 3/8 of 7/8 Post: 5/8 of 7/8 Working

 Working Interest Interest

 PP: First $50,000 of 1/8 of 8/8 Pre-Payout: Minerals (7/8)

 Post-Payout: Minerals (8/8)

 Any combo of minerals, working, Any continuing interest

 Interest, non-perpetual carried or combo of continuing

 Interest, & production payments interests

 3/32 Royalty 1/32 Royalty

Royalty

 (1/8) PP: First 1/8 out of 1/8 of 8/8 Pre-Payout: 0/8

 Post-Payout: 1/8

 3/4 of 7/8 Working Interest 1/4 of 7/8 Working Interest

Working Interest 3/4 of 7/8 Working Interest 1/4 of 7/8 ORIH

 (7/8)

 Pre-Payout: Carried Working Pre: 7/8 Working Interest

 Interest (Non-Perpetual, no

 Production until Payout)

Post-Payout: 3/4 of 7/8 Post: 1/2 of 7/8 Working

 Working Interest Interest

PP: First $50,000 of 3/8 of 7/8 Pre-Payout: 5/8 of 7/8

 Post-Payout: 7/8 Working

 Interest

 Any combo of minerals, working, Any continuing interest

 Interest, non-perpetual carried or combo of continuing

 Interest, & production payments interests

 1/16 of 7/8 ORIH 1/16 of 7/8 ORIH

Overriding Royalty

 (7/8) PP: (First $50k of 3/32 of 7/8) Pre: 1/32 of 7/8 ORIH

 Post: 1/8 of 7/8 ORIH

 NPI (10% of net profits) NPI (20% of net profits)

 NPI

(30% of net profits) PP: (first $50k of 25% net profits) Pre: NPI of 5%

 Post: NPI of 30%

Production Payment

 (First $50k of PP: (first $30k of 3/40 of 7/8) PP: ($20k of 1/20 of 7/8)

 1/8 of 7/8)

**Ex**: Lessor (A) sells 50% of mineral estate to B for $100,000. B agreed to bear entire costs of development/operating and to pay 1/6 of production

 **Effect**: Likely a lease bc A retained royalty **(1/6) (See Campbell v. Fasken)**

**Ex**: Lessor (A) owns surface and mineral estate with O&G reservoir. A assigns mineral estate to B for $100,000. A retains the surface estate

 **Minerals Estate**: Sale bc no retained interest in the minerals

**Ex**: Same, but under TX law, mineral estate reverts to A from B after 40 years, regardless of if there is production

 **Mineral Estate**: Still a sale **(too remove of reversion for tax purposes)**

**Other Issues**

**Gain, Loss, Timing, Character**: apply **IRC 1001** rules for gain/loss/character

**Recapture**: **IRC 1254**: recaptures IDC and depletion upon sale of properties

 **Pre-1986**: Yes IDC recapture (but no depletion recapture) is the property was

 placed in service before 1986

 **Ex**: In Y0, A bought entire working interest. From Y1-Y5, A developed. In Y5, A’s

 AB is $240. A took $75 of IDC deductions and $50 of depletion deductions. In

 Y5. A sells for $600 **Gain**: $360 total gain

 **IDC Recapture**: $75 recaptured at ordinary rates

 **Depletion Recapture**: $50 recaptured at ordinary rates

 **Ex**: Same facts, but, instead, A sold ORIH for $100 ($40 basis, IDC is $20)

 **Effect**: Under **RR 1.1254-1(b)(2)(iv)(2)**, recapture if the IDC deduction is likely

 **Gain**: $60 Gain

 **IDC Recapture**: $20 recaptured at ordinary rates

**Involuntary Conversion**: **IRC 1033**: allows for tax free replacement of property that were subject to involuntary conversions

 TP gets non-recognition and can defer gain if he acquires replacement property

 **Revenue Ruling 72-117**: ORIH ARE interests in real property and can count as

 replacement property

 **Ex**: TP’s land condemned. TP reinvesting proceeds in ORIH is OK

**Like-Kind Exchanges**

**IRC 1031** allows tax-free treatment of certain like-kind property

 O&G properties can generally be exchanged for other real property in the US

 **Foreign Property**: does NOT get like-kind treatment

**Non-Simultaneous Exchanges**: **IRC 1031** allows for non-simultaneous exchanges if TP meets the 45 day ID requirement and acquires the property within 180 days

**Elements**: ***1) Like-Kind Exchange;***

 ***2) Of Real Property***

 **Leases**: Leases ARE considered to be real property

 **Lease Equipment**: Equipment on the lease is NOT real property

 and would count as boot

 **Crichton**: Real property’s meaning is SUPER broad

 **Revenue Ruling 68-331**: Exchange of an O&G lease for a fee

 interest in land is a like-kind exchange

 ***3) Held for productive use in T/B or for investment***

**Ex**: A owns working interest in unproven O&G lease ($20 AB). No IDC deductions. A transfers lease to B for $40 in exchange for working interest in a proven O&G lease

 **Effect**: yes like-kind exchange **(working & royalty interests in natural resource**

 **properties are like-kind properties)**

**Ex**: Same, but the property A got is a royalty interest

 **Effect**: Yes like-kind exchange **(working interest for royalty is OK)**

**Ex**: Same, but the property A got is a in solid mineral, non-O&G property

 **Effect**: Yes like-kind exchange **(O&G property for solid mineral property)**

**Ex**: Same, but the property A got is a an apartment building

 **Effect**: yes like-kind exchange **(O&G property for improved real estate)**

**Ex**: Same, but the property A got is a home that A will live in

 **Effect**: NOT like-kind exchange

**Ex**: Same, but A is a dealer in O&G working interests

 **Effect**: NOT like-kind exchange under **IRC 1031(a)(2)(A)** bc A is a dealer

**Write-Offs/Deductions of O&G Property**

***Generally***

**General Rule**: **IRC 165(a)**: yes deduction for any loss in the year

**Amount of Deduction**: **IRC 165(b)**: Basis for the amount of deduction is the AB

**Limits**: **IRC 165(c)**: For individuals, deduction is limited to **(1)** losses incurred in T/B

***Abandonment & Worthlessness***

**General Rule**: **IRC 62(a)**: “AGI” means gross income minus deductions for:

 1) **IRC 62(a)(1)**: T/B expenses

 2) **IRC 62(a)(4)**: Costs incurred in producing income related to depletion

***Worthlessness***

If TP is attempting to argue that the mineral estate is worthless, must determine whether the minerals have been severed from the surface

**Henley**: If TP owns the surface and mineral estate, TP can NOT write of just the mineral estate while TP still has rights to those minerals

 If TP later sold the mineral estate, then TP could write off the loss (bc it’s a sale)

 If TP does NOT later sell the mineral estate, can NOT deduct the mineral estate

**Establishing Worthlessness**: **Harmon**: the mere possibility of future production is not, itself, enough to give value to royalties which have been deemed to be worthless by TP engaged in developing O&G

 Need NOT be the world’s biggest optimist to say that the minerals are worthless

 OK to say the minerals are worthless, even if there’s **~some~** chance of

 commercial production

***Abandonment***

To get abandonment loss, TP must show he had intent to abandon the property

**Elements**: ***1) Intent to abandon***

 ***2) Over act of abandonment***

***Overt Act***

**Continued Delay Rental Payments**: if TP stops paying delay rentals, it is more likely an overt act bc it’d mean TP would lose all of his rights in the lease

 **Brountas**: If TP keeps paying delay rental payments, TP has NOT performed an

 overt act bc TP still thinks there is some value in the property

 If TP abandoned & stopped delay rentals, CAN take abandonment deduction

**Separate Property Elections**: Merely having properties treated separately does NOT, itself, give TP the right to claim abandonment/worthlessness

 Just bc TP treats part of the property on a lease as a separate property does

 NOT mean TP will get a partial-abandonment write-off

 **Gulf** **Oil**: TP can NOT abandon different horizontal stratas

 TP can NOT write off bc TP had 1 lease that covered multiple horizons

 If TP doesn't get rid of lease for all horizons, TP can't get abandonment

 If TP keeps paying delay rentals and has the legal right to produce from

 that horizon, no deduction bc the lease isn't abandoned

 **PROF**: **No partial write-offs!**

**Ex**: Lessor (A) and lessee (B) enter lease of 1,000 foot tract. A gets bonus and 1/8 royalty. A has basis in the minerals. A capitalized IDC costs. Production in the area. In Y2, B drills dry hole and decides to not develop. B doesn't give up tract until Y5

 **Year 2**: **A’s POV**: No write off for mere decline in value **(See Henley)**

 **B’s POV**: No write off **(production in the area & small tract)**

 **Year 5**: **B’s POV**: yes worthlessness write off under **Gulf Oil** & **Brountas**

**Ex**: Same facts, but B drilled 3 dry holes on different areas of the tract

 **Year 2**: **A’s POV**: No write off

 **B’s POV**: Yes write off **(multiple dry holes on same tract)**

**Ex**: Same facts, but B drilled 3 dry holds on different areas of the tract. B pays delay rentals in Y2

 **Year 2**: **A’s POV**: No write off

 **B’s POV**: No write off **(paid delay rentals)**

**Ex**: Same facts, but B drilled 3 dry holes on different areas of the tract. In Y3, B drills a productive well

 **Effect**: A later drilled producing well or dry hole is NOT determinative on B’s

 earlier worthless claim from prior years

**Ex**: Same facts, but B drilled 3 dry holes on different areas of the tract. B drilled 1 producing well on the same tract

 **Effect**: B can NOT take a partial worthlessness write-off for the dry holes