SELECTED TRANSACTIONAL ISSUES IN OIL AND GAS TAX TAXATION

by

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I. Introduction

Common Tax Objectives

a. Common tax objectives to achieve the lowest present value after-tax rate of return on investments in oil and gas are:
   i. Achieve current deductibility-accelerate deductions whenever possible;
   ii. Defer recognition of income and gain and insure that it occurs on a time line consistent with receipt of cash on an endgame/liquidity event; and
   iii. Reduce to the lowest tax rate possible the incidence of taxation when income/gain is recognized.

Current Tax Environment for Energy/Oil and Gas

b. Uncertainty over tax rates-the Bush era tax rate cuts extensions expire as of 12/31/2012. Whether they will be extended is uncertain. Also, application of the 3,8% Medicare add-on beginning 1/1/2013.
c. So far, no carried interest legislation (taxation of profits interests) has been enacted but it continues to be discussed for revenue raising and policy reasons. So still a planning consideration and one that should be considered.
d. So far, no wholesome repeal of perceived tax benefits for the oil and gas industry (for example, repeal of the IDC deduction, repeal or cutback of percentage depletion, etc.). But this could change now that the elections have occurred.
e. Currently, a mix of conflicting considerations. We have post-election posturing and uncertainty, a divided Congress, a desire to stimulate the economy and create jobs, budget deficits, anti-nuke sentiment after Japan, the much publicized waste on alternative energy (the solar energy scandal), the likely reduction or lapse of tax credits for wind energy and increasing oil and gas reserves due to new technology (shale, tar sands, etc.) and lower commodity prices. As a result, there is considerable uncertainty about what the future holds from a economic standpoint for the oil and gas industry as well as uncertainty about the tax landscape. Also, we have a new found resource for oil and gas production in the form of shale.

What is Unique About Shale for an Oil and Gas Tax Perspective?

f. Other than what may exist from a state and local tax perspective, the federal taxation of shale is no different or unique compared to other forms of oil and gas interests. However, there are factual and economic differences that result in a different tax profile.
g. Shale reserves are usually long-lived. So annual depletion/cost recovery is less because tax basis is spread over a longer production life.
h. Shale development requires the acquisition of large tracts of land/acreage. So front-end acquisition costs are higher.
i. Drilling and development is more expensive because of horizontal drilling and hydraulic fracturing that must be applied to create production. Also, to fully develop an area, the

type of drilling and development employed is more comprehensive and complicated. No such thing as "one well" except if it is an exploratory well.

j. The geology will differ from area to area and requires different drilling techniques, which further insures it will be expensive.

k. Perceived higher level of environmental risk, which creates larger contingent liabilities as to groundwater contamination and plugging and abandonment.

Identifying the Investors in Oil/Gas and Shale

l. 2010/2011 studies by the Big 4 accounting firms indicate that independent oil and gas and shale midstream build-out is focused upon and funded primarily by the areas of private equity, independent E&P companies and midstream MLPs.

m. 50% or more of the companies were private equity backed companies operating in flow-through form.

n. This is reflective of both oil and gas in general and shale development.

o. Accordingly, except for the shale development being conducted by the large publicly traded players (which operate in C corp form), the balance is being performed by companies operating in flow-through form. Therefore, most operating and investor entities operating in the independent oil and gas, shale and midstream environment will be in partnership form for federal and state tax purposes.

Why Flow-Through Form?

p. Allows for an efficient allocation of IDCs and deductions to the investors by specially allocating these deductions to the investors who are funding the cash.

q. Provides more flexibility to compensate management in a tax preferred manner by issuing profits interests in a tax partnership. Same applies to the upstream promoters (the PE funds) that have aggregated the capital for investment in the area.

r. Provides for a potentially higher price on a cash sale exit because the buyer receives a step-up in tax basis in either an asset or equity sale. Studies indicate there is as much as a 15% to 20% premium received in sales price as compared to sales in C corp form. The one exception to this is in the IPO area, in which value is a function of multiples and EBITDA (earnings before interest, taxes, depreciation and amortization), without regard to taxes. The reason why the up-C IPO[1] structure is a possibility.

s. Allows for greater flexibility upon exit/partial exit and more creative approaches. For example, IPOs, up-C IPOs, asset sales, equity sales and various forms of disguised sales or debt-financed distributions.

What This Outline Will Cover.

[1] The up-C IPO structure is similar to the up-REIT structure developed and widely utilized in the late 80s and 1990s. It is one in which the E&P or midstream assets that are subject to the IPO were originally held in flow-thru form and they remain so underneath the public entity, which holds the majority ownership and control. As partnership interests are "put" to the public entity by the founders in exchange for common stock, this taxable exchange results in a basis step-up in the underlying assets pursuant to Section 754 of the Code. 80%-90% of this tax benefit to the public company is repaid to the founders over a period of years pursuant to a tax sharing agreement.

What follows is a traditional discussion of the many of the principles and rules that relate to oil and gas taxation for federal tax purposes. When appropriate, however, specific discussion has been added to address issues that are common with the acquisition, development, operation and sale/exit of oil and gas and shale properties.

II. Classification Of Interests

a. Operating vs. Non-Operating
   i. Operating Interest – an Interest burdened with the Costs of Development and Production; generally a Lease/Working Interest
   ii. Non-Operating Interest – an Interest Free of the Costs of Development and Production; generally a Royalty, Overriding Royalty or Net Profits Interest. Certain Production Payments and Carried Interests are also considered Non-Operating Interests.
   iii. Working Interests
      1. Definition -- an interest in minerals in place that is burdened with the cost of development and operation of the property. *Brooks v. Comm'r.*, 424 F2d 116, (5th Cir. 1970).
      2. A lessee under an oil and gas or mineral lease is the classic working interest holder. A taxpayer may retain the working interest throughout the life of the lease or he may assign a portion of the working interest to another party in exchange for funds for development of the property. (*See* discussion of Farm-Outs below).

b. Non-Operating Interests – Royalty
   i. Definition- a right to oil and gas or other minerals in place that entitles its owner to a specified fraction, in-kind or in value, of the total production from the property, free of expense of development and operation. *Getty Oil Co. v. U.S.*, 399 F2d 222 (Ct. Cl. 1968).
   ii. If a landowner executes an oil and gas lease, he typically reserves a royalty interest. The lessee may then sublease the mineral rights, reserving an overriding royalty interest.
   iii. A royalty or overriding royalty may also be assigned by the working interest owner (*i.e.*, carved out).

c. Non-Operating Interests – Net Profits Interests
   i. Definition – an interest in minerals in place that is defined as a share of gross production measured by net profits from operation of the property. *Burton Sutton Oil Co., Inc. v. Comm'r.,* 328 U.S. 25 (1946).
   ii. A net profits interest is similar to a royalty or overriding royalty except that it is measured by net profit (i.e., reduced by costs of production) rather than gross production.

d. Non-Operating Interest – Production Payment